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CONDUCT OF MONETARY POLICY

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CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 21, 1982

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Reuss, Gonzalez, Minish, Fauntroy, Neal, Hubbard, LaFalce, D'Amours, Lundine, Vento, Barnard, Lowry, Patman, William Coyne, Hoyer, Stanton, Wylie, McKinney, Hansen, Leach, Evans, Paul, Parris, Weber, McCollum, Carman, Wortley, Roukema, Lowery, James Coyne, and Dreier.

The Chairman. The committee will come to order.

These hearings invariably take on a deja vu quality. That is d-e-j-a v-u. [Laughter.]

A year ago, the Nation was beginning to slide into the Regan-Reagan recession-depression. The Federal Reserve Chairman came before us, as he and his predecessors have for many years, to reaffirm that the holy crusade against inflation was still on full scale. For those who expressed concern about rising unemployment, high interest rates, and business bankruptcies, the answer was a soothing call for time and patience.

When Chairman Volcker sat down to pronounce his doctrine of time and patience on July 21, 1981, the Nation's unemployment rate stood at 7.2 percent. After 1 year of time and patience, the unemployment rate stands at 9.5 percent, 3 million people who had jobs July 21, 1981, no longer work.

Today Chairman Volcker will again tell us that the Federal Reserve is continuing to slay the inflationary dragons. While the counsel of time and patience may have been omitted from this year's text, it is implied that businesses which have disappeared and the workers who line up for unemployment should realize that their needs must await the Federal Reserve's and the administration's return from the never-ending crusade against inflation.

All of us, I believe, join in the concern about the dislocations caused by inflation, and none of us would minimize the importance. But many of us do object to the one-dimensional approach of the Fed and the administration, and many of us do realize that the statistics of inflation look better only because the economy has been devastated and people have been thrown out of work. Let us remember that the inflation rate was less than zero in the Great Depression.

In the past year we've had little but cosmetic changes in interest rates and many of the key rates, such as the mortgage and corporate bond rates, have remained far out of the reach of all but the most affluent. It is indeed clutching at straws to become excited about the difference in a 17-percent and a 16-percent prime. They are both disastrous. It's like talking about the difference in the prices of Jaguars and Rolls-Royce automobiles to the gentleman who cannot afford a bicycle.

Once again, the Federal Reserve commends the Congress for adopting budget resolutions reducing social programs. At the same time, I note that the Federal Reserve's social programs for the banks—bargain basement loans at the discount window—are increasing, if news reports are correct. I hope that the Federal Reserve Chairman will take time today to explain just how the discount window is being utilized and its role as a bailout mechanism in such cases as the recently failed Penn Square Bank.

It is also important that the committee fully understand how these discount window operations, particularly those which help to paper over banking errors, might affect the money supply and the open market operations of the Fed.

I have the greatest respect for the current Chairman of the Federal Reserve. I have worked closely with him on many issues. However, to be frank, the Nation is not happy with the results of the economic policies of either the Federal Reserve or the administration, good intentions notwithstanding. In fact, they are sorely disappointed if not angry, and they expect change, change which can be felt at the grassroots. They do not want another dose of rosy projections. They want results.

The people will not tolerate indefinitely monetary and fiscal policies that leave 10 million without work and create record farm and business failures and force the abandonment of longstanding commitments to our elderly and to the poor.

Mr. Stanton?

Mr. **Stanton**. Thank you very much, Mr. Chairman.

Before welcoming the Chairman before our committee, I should also add, of course, that the country is not happy with the fiscal policies of the U.S. Congress and the administration as well. I see no applause being given to the Congress as far as I can see back in my congressional district. So there is indeed, with the economy, and as far as the operations of Government are concerned, plenty of room to take the blame.

But Mr. Chairman, I welcome you here before our committee at the semiannual hearings to fulfill the legislative mandate of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1976. Mr. Chairman, it has dawned upon me that this probably will be the last Humphrey-Hawkins hearings that Chairman Reuss and I will have the privilege to attend as members of the Banking Committee. Both of us were instrumental in the setting up of these hearings and the establishment of the procedures by which you appear semiannually before the two bodies of Congress.

I think it is appropriate at this time to state that you are indeed acting out the mandate of the Congress, and as such you are responsible to the members of this committee, and through us to the Congress and to the people. The fact is that the Federal Reserve is a creature of the Congress. It has always bothered me over the years, when administrations from time to time would get the impression that the Federal Reserve was established by the executive branch of the Government, as if they have some type of control or authority over this body.

But indeed, your appearance here today reiterates that the Federal Reserve is, from the beginning, a creature of Congress. I think further, that in going over the transcript of the exchange of letters between you and the chairman of the Joint Economic Committee, you cleared the air before both of us leave on an important point as far as the independence of the Fed is concerned.

Chairman Reuss, in his June 2 press release, did an outstanding job of explaining the need for the independence of the Fed. Chairman Reuss fully agreed with Chairman Volcker's assertion that "* * * monetary policy manipulated toward short-term or partisan purposes could have potentially adverse repercussions for our economy." We are very glad that the Federal Reserve is taking the overall larger view.

I think, Mr. Chairman, if history teaches us anything, it shows that inflation is triggered by an excessive growth of the money supply. Thus the remedies for both inflation and high interest rates call for appropriate and consistent restraint in the growth of money and credit over the longer term to achieve the goals of sustainable economic growth at stable prices.

I believe, Chairman Volcker, that the Federal Reserve's existing monetary targets in 1982 and their planned continuation through 1983 will serve that purpose. To provide the fiscal complements to your monetary policy, it is essential that we in Congress enact a credible budget and, more than that, that we stand fast when the appropriations bills are considered on the floor.

Mr. Chairman, I welcome you here this morning and look forward to your testimony, and also the questions that will follow.

The CHAIRMAN. Chairman Reuss?

Mr. REUSS. Thank you, Mr. Chairman. I will be brief, because my views are deja entendu and I will not go into them at length.

I welcome my friend Paul Volcker, but I do have to express my unhappiness at the action of the Federal Reserve Open Market Committee. In your report, Chairman Volcker, you are telling us that the Open Market Committee projects a nominal growth rate of the economy for 1983 of 7 to 9½ percent. Yet you intend to finance that growth rate by a money supply, M_1 growth rate, of 2½ to 5½ percent.

If it does not work and if interest rates rise, I will be asking you when my question time comes whether you are prepared to change your policy to prevent a further disastrous rise in interest rates.

My second concern, one I have voiced before, has to do with your 2½- to 5½-percent band. You tell us that you intend to aim for the 5½-percent upper limit of the band, and if you go over that not to worry. Well, I do worry, and I think the markets will worry, because this to me is brinksmanship.

If you adopt as your target the very outer limit of that which you have said is the limit of prudence and you go over it, the markets are going to flip, as they have been flipping for many months, and we are going to have a continuation of our miseries.

When you attempt to be all things to all people—to please the avid tight money super-monetarists by a 2½-percent lower limit, and also attempt to place the populists by saying, "well, if we go over the top of the limit, do not worry," I think that you are debauching the congressional and Federal Reserve monetary targeting process.

If 5½ percent is your target, I do not see why you do not make your range 4 percent to 7 percent, so that 5½ percent would be the middle of it and you would have some earthly chance of realizing it.

These are my concerns. I offer them in good humor and I know you will reply in the same vein.

The **Chairman**. And as well, the very stable and levelheaded comments of Mr. Stanton.

I would like to state that I am glad Bill brought it to our attention. It involves so many other things, but indeed this is the last time we will have these two very distinguished gentleman who have served their districts and their country so well with us in these hearings. Frankly, it is with deep regret that we have to note the fact that this will be their last participation in Humphrey-Hawkins-type hearings.

So I would just like to state—and I am sure you may make an observation when we finally get to you, Mr. Wylie [laughter], that I indeed am going to miss them, and I am sure all of my colleagues shall as well.

Mr. Wylie?

Mr. **Wylie**. Mr. Chairman, thank you very much.

I too want to express my regret that Chairman Reuss and Bill Stanton, who have served with such distinction and have served the country with aplomb and have contributed mightily to the process of this Banking Committee, will not be with us for the next hearing.

I think that Chairman Reuss in his statement a little while ago provided a setting for some of the exchange here this morning. And may I say, the reason I wanted to make a little brief statement at this point is that I am the recipient of some happy news, and I think maybe the chairman has it, too. I am a little bit more optimistic about what is happening as far as our economy is concerned.

I do not sense the debauchery going on that the chairman has suggested. But the good news that I have just been given here is that the Commerce Department announced that the second quarter estimate for real GNP indicates an increase of 1.7 percent. This is very good news relative to many expectations, and I am sure that will be referenced. It was anticipated that the increase for the second quarter would only be about six-tenths of 1 percent.

But may I also then say, I want to congratulate Chairman Reuss and Bill Stanton for the excellent service they have rendered this committee and tell them how much I too will miss them.

Thank you very much, Mr. Chairman.

The **Chairman**. Mr. Fauntroy?

Mr. **Fauntroy**. Thank you, Mr. Chairman.

I too want to associate myself with your remarks, Mr. Chairman, with respect to both Bill Stanton and Joint Economic Committee Chairman Reuss, and to welcome, as well, Chairman Volcker.

As we once again hold our semiannual hearings on the conduct of monetary policy, I think it is important to remember that our ultimate concern, and the ultimate objective of the Federal Reserve should be with the realities of inflation, economic growth and employment, and not necessarily with the behavior of various artificial monetary aggregates. Monetary targets are a means to an end, not an end in themselves, and we should not be fooled into giving them more attention than they deserve.

I raise this obvious question because there is increasing evidence that the present monetary aggregates, and particularly the M_1 aggregate, are seriously flawed as immediate targets for obtaining our ultimate objectives of lower inflation, lower unemployment, and strong balanced economic growth. Just last week, my subcommittee held hearings on this question, and three prominent economists testified that the meaning of the M_1 aggregate had become badly distorted by financial innovations. The resulting risks would be that rigid adherence to current monetary targets could produce perverse results, including prolonged economic recession and high unemployment and bankruptcy rates.

I believe that the Federal Reserve is aware of these risks, since Chairman Volcker has already cautioned that the M_1 aggregate may be artificially inflated by the growth of precautionary savings balances in NOW accounts, although I am not sure that the Fed is going far enough to foster a sound recovery.

I am even less sure that the administration, with its theory that the flow of money should be steadily reduced to a sprinkle, is aware of the risks of an inflexible reduction in money supply. Consequently, I believe that this committee and the Federal Reserve should give serious consideration to a recommendation made by the subcommittee's witnesses, that the current monetary targets be replaced or supplemented by appropriate broader credit aggregates. If that happened, there would be a greater likelihood that we would have a monetary policy that would promote a strong recovery without a resurgence of inflation.

Such a policy could enlarge the range of policy options pursued by the Fed so that its actions might be able to more appropriately reflect past and prospective developments in employment, unemployment, production, investment, productivity, international trade, payments and prices, thereby lessening some of the impact of the fight against inflation on the employment rate. Those who are interested in pursuing this matter, Mr. Chairman, may want to review last week's hearings by our Subcommittee on Domestic Monetary Policy.

Mr. Chairman, I want to thank you for yielding and I look forward to hearing from Mr. Volcker.

The CHAIRMAN. Are there any further requests?

[No response.]

The CHAIRMAN. If not, the time you have been awaiting with bated breath has arrived. Mr. Chairman, we welcome you. We will put your statement and the appendixes in the record, and you may proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman VOLCKER. Thank you, Mr. Chairman.

Let me say, first of all, that it is not as a formality that I join wholeheartedly in the comments that you and others have made about Mr. Reuss and Mr. Stanton leaving the Congress. It seems to me they both represent, I might say in quite different ways, what I conceive of as the best in congressional and Federal Reserve relationships.

We never lose sight of the fact that we are a creature of the Congress, and their intelligent and thoughtful input and concern about the Federal Reserve has been of great help to us in that setting. I think these hearings, in general, reflect the nature of those congressional and Federal Reserve relationships.

The hearings have been helpful in bringing out various facets of policy and in extending the policy debate, which is always necessary in this country. And the leadership of the two gentlemen on either side of you has been immensely important in that whole process.

Perhaps the best way for me to proceed is to read you some excerpts from my statement—I delivered the whole testimony before the Senate yesterday—to set the stage for your questions.

The CHAIRMAN. Without objection, we will put that entire statement in the record.

Chairman VOLCKER. I will just read parts of the statement then, Mr. Chairman.

In these past 2 years, we have traveled a considerable way toward reversing the inflationary trend of the previous decade or more. I would recall to you that by the late 1970's that trend had shown every sign of feeding upon itself and tending to accelerate to the point where it threatened to undermine the foundations of our economy. Dealing with inflation was accepted as a top national priority, and as events developed that task fell almost entirely to monetary policy.

In the best of circumstances, changing entrenched patterns of inflationary behavior and expectations is difficult and potentially a painful process. Those, consciously or not, who had come to bet on rising prices and the ready availability of relatively cheap credit to mask the risks of rising costs, poor productivity, aggressive lending, or overextended financial positions have found themselves in a particularly difficult position.

The pressures on financial markets and interest rates have been aggravated by concerns over prospective huge volumes of Treasury financing, and by the need of some businesses to borrow at a time of a severe squeeze on profits. Lags in the adjustment of nominal wages and other costs to the prospects for sharply reduced inflation are perhaps inevitable, but have the effect of prolonging the pressure on profits—and indirectly on financial markets and employment.

Remaining doubts and skepticism that public policy will carry through in the effort to restore stability also affect interest rates, perhaps most particularly in the longer term markets.

Now, I am acutely aware that the gains against inflation have been achieved in the context of a serious recession. Millions of workers are unemployed, many businesses are hard-pressed to maintain profitability, and business bankruptcies are at a postwar high.

Quite obviously, a successful program to deal with inflation, with productivity, and with the other economic and social problems we face cannot be built on a crumbling foundation of continuing recession. As you know, there have been some indications—most broadly reflected in the rough stability of the real GNP in the second quarter, to which Mr. Wylie has just referred, actually in the current estimate up about 1¾ percent—that the downward adjustments may be drawing to a close.

The tax reduction effective July 1, higher social security payments, rising defense spending and orders, and the reductions in inventory already achieved, all tend to support the generally held view among economists that some recovery is likely in the second half of the year.

I am also conscious of the fact that the leveling off of the GNP has masked continuing weaknesses in important sectors of the economy. In sum, we are in a situation that obviously warrants concern but also has great opportunities. Those opportunities lie in major part in achieving lasting progress—in pinning down and extending what has already been achieved—toward price stability. In doing so, we will be laying the base for sustaining recovery over many years ahead, and for much lower interest rates, even as the economy grows.

I am certain that many of the questions, concerns and dangers in your mind lie in the short run, and that those in good part revolve around the pressures in financial markets.

Can we look forward to lower interest rates to support the expansion in investment and housing as the recovery takes hold? Is there in fact enough liquidity in the economy to support expansion but not so much that inflation is reignited? Will in fact the economy follow the recovery path so widely forecast in coming months? These are the questions that we in the Federal Reserve must deal with in setting monetary policy.

In reviewing the first half of the year, Mr. Chairman, you are aware that M_1 and M_2 both remained somewhat above the straight-line paths implied by our targets until very recently. M_3 and bank credit have remained generally within the indicated range although close to the upper ends. Taking the latest full month of June, M_2 grew 5.6 percent from the base period, and M_1, 9.4 percent, close to the top of the ranges. Through the second quarter as a whole, the growth was higher.

In conducting policy during this period, the committee was sensitive to indications that the desire of individuals and others for liquidity was unusually high, apparently reflecting concerns and uncertainties about the business and financial situation.

One reflection of that may be found in unusually large declines in velocity over the period: that is, the ratio of measures of money to the gross national product. M_1 velocity, particularly for periods as short as 3 to 6 months, is historically volatile. A cyclical tendency to slow during recessions is common, but an actual decline for two consecutive quarters as happened late in 1981 and the first quarter of 1982 is rather unusual.

The magnitude of the decline during the first quarter was larger than in any quarter of the entire postwar period. Moreover, declines in velocity of this magnitude and duration are often accompanied by reduced short-term interest rates. Those interest rate levels during the first half of 1982 were distinctly lower than during much of 1980 and 1981, but they did rise above the levels reached in the closing months of last year.

I review some other evidence about liquidity demands in the next few pages of the statement. In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transactions' purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregates appeared inappropriate. Such an effort would have required more pressure on bank reserve positions and presumably more pressures on the money markets and interest rates in the short run.

At the same time, an unrestrained buildup of money and liquidity clearly would have been inconsistent with the effort to sustain progress against inflation. Periods of velocity decline over a quarter or two are typically followed by periods of relatively rapid increase. Those increases tend to be particularly large during cyclical recoveries. Indeed, velocity appears to have risen slightly during the second quarter, and the growth in NOW accounts has slowed.

Judgments on these seemingly technical considerations inevitably take on considerable importance in the target setting process because the economic and financial consequences, including the consequences for interest rates of a particular M_1 or M_2 increase, are dependent on the demand for money. Over longer periods a certain stability in velocity trends can be observed, but there is a noticeable cyclical pattern.

Taking account of these normal historical relationships of various targets established at the beginning of the year were calculated to be consistent with economic recovery in the context of declining inflation. That remains our judgment today. Inflation has in fact receded more rapidly than anticipated, potentially leaving more room for real growth.

On that basis, the targets established earlier in the year still appear broadly appropriate and the Open Market Committee decided not to change them at this time. However, the committee did feel in light of developments during the first half that growth around the top of those ranges would be fully acceptable. Moreover, and I would emphasize this, growth somewhat above the targeted ranges would be tolerated for a time.

In circumstances in which it appeared that precautionary or liquidity motivations during a period of economic uncertainty and turbulence were leading to stronger than anticipated demands for money, we will look to a variety of factors in reaching that judgment, including such technical factors as the behavior of different components in the money supply, the growth of credit, the behavior of banking and financial markets, and more broadly, the behavior of velocity and interest rates.

I believe it is timely for me to add that in these circumstances the Federal Reserve should not be expected to respond and it does not plan to respond strongly to various bulges or, for that matter, valleys in monetary growth that seem likely to be temporary.

In looking ahead to 1983, the Open Market Committee agreed that a decision at this time would even more obviously than usual need to be reviewed at the start of the year in the light of all the evidence as to the behavior of velocity of money and liquidity demand during the current year. Apart from the cyclical influences now at work, the possibility will need to be evaluated of a more lasting change in the trend of velocity.

I analyze, in the next paragraph, some conflicting considerations bearing on that trend in velocity. I conclude that to say that the trend has in fact changed would be clearly premature, but it is a matter we will want to evaluate carefully as time passes. For now, the committee felt that the existing targets should be tentatively retained for next year.

Since we expect to be around the top end of the ranges this year, those tentative targets would, of course, be fully consistent with somewhat slower growth in the monetary aggregates in 1983. Such a target would be appropriate on the assumption of a more or less normal cyclical rise in velocity. With inflation declining, the tentative targets would appear consistent with and should support continuing recovery at a moderate pace.

The Congress in adopting a budget resolution contemplating cuts in expenditures and some new revenues also called upon the Federal Reserve to reevaluate its monetary targets in order to assure they are fully complementary to a new and more restrained fiscal policy.

I can report that members of the committee welcome the determination of the Congress to achieve greater fiscal restraint. I particularly want to recognize the leadership of the members of the Budget Committee and others in achieving that result. That result has been achieved in most difficult circumstances. But I would be less than candid if I did not also report a strong sense that considerably more remains to be done to bring the deficit under control as the economy expands.

The fiscal situation as we appraise it continues to carry the implicit threat of crowding out business investment in housing as the economy grows, a process that would involve interest rates substantially higher than would otherwise be the case.

For the more immediate future, we recognize the need remains to convert the intentions expressed in the budget resolution into concrete legislative action. In carefully considering the question posed by the budget resolution, the Open Market Committee felt that full success in the budgetary effort should itself be a factor contributing to lower market interest rates and reduced strains on financial markets. It would thus assist importantly in the common effort to reduce inflationary pressures in the context of a growing economy.

By relieving concern about future financing volume and inflationary expectations, I believe as a practical matter a creditably firmer budget posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears. Specifically, market anxiety that short-run increases in the M's might presage continuing monetization of the debt could be ameliorated, but any gains in these respects will, of course, be dependent on firmness in implementing the intentions set forth in the resolution and on encouraging confidence among borrowers and investors alike that the effort will be sustained and reinforced in coming years.

Taking account of all these considerations, the committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have set out here. Indeed, excessive monetary growth and perceptions thereof would undercut any benefits from the budgetary effort with respect to inflationary expectations.

We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

Now let me say that in an ideal world, less exclusive reliance on monetary policy to deal with inflation would no doubt have eased the strains and high interest rates that plague the economy and financial markets today. To the extent the fiscal process can now be brought more fully to bear on the problem, the better off we will be.

Efforts in the private sector to increase productivity, to reduce costs and to avoid inflationary and job-threatening wage increases are also vital. Even though the connection between the actions of individual firms and workers in the performance of the economy may not always be self-evident to the decisionmakers, we know progress is being made in these areas and more progress will hasten full and strong expansion.

We also know that we do not live in an ideal world. There is strong resistance to changing patterns of behavior ingrained over years of inflation. The slower the progress on the budget, the more industry and labor build in cost increases in anticipation of inflation or Government acts to protect markets or impede competition. The more highly speculative financing is undertaken, the greater the threat that available supplies of money and credit will be exhausted in financing rising prices instead of new jobs and growth.

We cannot escape those dilemmas by a decision to give up the fight on inflation. Such an approach would be transparently clear not to just you and me but to the investors, to businessmen and to the workers who would once again find their suspicions confirmed that they better prepare to live with inflation and try to keep ahead of it.

The reactions in financial markets and other sectors of the economy would in the end aggravate our problems, not eliminate them. I recognize months of recession and high interest rates have contributed to a sense of uncertainty. Businesses have postponed investment plans. Financial pressures have exposed lax practices and stretch balance sheet positions in some institutions, financial as well as nonfinancial. The earnings position of the thrift industry remains poor.

But none of these problems can be dealt with successfully by reinflation or by a lack of individual discipline. It is precisely that environment that contributed so much to the current strains and difficulties. In constrast, we are now seeing new attitudes of cost containment and productivity growth, and ultimately our industry will be in a more robust, competitive position. Millions are benefiting from less rapid price increases or actually lower prices at their shopping centers and elsewhere.

Consumer spending appears to be moving ahead and inventory reductions help to set the stage for production increases. Those are developments that should help recovery get firmly underway. The process of disinflation has enough momentum to be sustained during the early stages of recovery. That success can breed further success as concerns about inflation recede further.

As recovery starts, the cash flow of business should improve, and more confidence should encourage greater willingness among investors to purchase longer debt maturities. Those factors should in turn work toward reducing interest rates and sustaining them at lower levels, encouraging the revival of investment in housing that we want.

I have indicated the Federal Reserve is sensitive to the special liquidity pressures that could develop during the current period of uncertainty. Moreover, the basic solidity of our financial system is backstopped by a strong structure of governmental institutions precisely designed to cope with the secondary effects of isolated failures.

The recent problems related largely to the speculative activities of a few highly leveraged firms can and will be contained, and over time an appropriate sense of prudence in taking risks will serve us well.

We have been through--we indeed are in a trying period, but too much has been accomplished not to move ahead and complete the job of laying the groundwork for a much stronger economy. As we look ahead, not just to the next few months but for the long years, the rewards will be great and renewed stability in growth and in higher employment and standards of living. That vision will not be accomplished by monetary policy alone, but we do mean to do our part.

Thank you, Mr. Chairman.

[The prepared statement of Chairman Volcker follows:]

PREPARED STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I am pleased to have this opportunity once again to discuss monetary policy with you within the context of recent and prospective economic developments. As usual on these occasions, you have the Board of Governors' "Humphrey-Hawkins" Report before you. This morning I want to enlarge upon some aspects of that Report and amplify as fully as I can my thinking with respect to the period ahead.

In assessing the current economic situation, I believe the comments I made five months ago remain relevant. Without repeating that analysis in detail, I would emphasize that we stand at an important crossroads for the economy and economic policy.

In these past two years we have traveled a considerable way toward reversing the inflationary trend of the previous decade or more. I would recall to you that, by the late 1970s, that trend had shown every sign of feeding upon itself and tending to accelerate to the point where it threatened to undermine the foundations of our economy. Dealing with inflation was accepted as a top national priority, and, as events developed, that task fell almost entirely to monetary policy.

In the best of circumstances, changing entrenched patterns of inflationary behavior and expectations -- in financial markets, in the practices of business and financial institutions, and in labor negotiations -- is a difficult and potentially painful process. Those, consciously or not, who had come to "bet" on rising prices and the ready availability of relatively cheap credit to mask the risks of rising costs, poor productivity, aggressive lending, or over-extended financial positions have found themselves in a particularly difficult position.

The pressures on financial markets and interest rates have been aggravated by concerns over prospective huge volumes of Treasury financing, and by the need of some businesses to borrow at a time of a severe squeeze on profits. Lags in the adjustment of nominal wages and other costs to the prospects for sharply reduced inflation are perhaps inevitable, but have the effect of prolonging the pressure on profits -- and indirectly on financial markets and employment. Remaining doubts and skepticism that public policy will "carry through" on the effort to restore stability also affect interest rates, perhaps most particularly in the longer-term markets.

In fact, the evidence now seems to me strong that the inflationary tide has turned in a fundamental way. In stating that, I do not rely entirely on the exceptionally favorable consumer and producer price data thus far this year, when the recorded rates of price increase (at annual rates) declined to 3½ and 2½%, respectively. That apparent improvement was magnified by some factors likely to prove temporary, including, of course, the intensity of the recession; those price indices are likely to appear somewhat less favorable in the second half of the year. What seems to me more important for the longer run is that the trend of underlying costs and nominal wages has begun to move lower, and that trend should be sustainable as the economy recovers upward momentum. While less easy to identify -- labor productivity typically does poorly during periods of business decline -- there are encouraging signs that both management and workers are giving more intense attention to the effort to improve productivity. That effort should "pay off" in a period of business expansion, helping to hold down costs and encouraging a revival of profits, setting the stage for the sustained growth in real income we want.

I am acutely aware that these gains against inflation have been achieved in a context of serious recession. Millions of workers are unemployed, many businesses are hardpressed to maintain profitability, and business bankruptcies are at a postwar high. While it is true that some of the hardship can reasonably be traced to mistakes in management or personal judgment, including presumptions that inflation would continue, large areas of the country and sectors of the economy have been swept up in more generalized difficulty. Our financial system has great strength and resiliency, but particular points of strain have been evident.

Quite obviously, a successful program to deal with inflation, with productivity, and with the other economic and social problems we face cannot be built on a crumbling foundation of continuing recession. As you know, there have been some indications -- most broadly reflected in the rough stability of the real GNP in the second quarter and small increases in the leading indicators -- that the downward adjustments may be drawing to a close. The tax reduction effective July 1, higher social security payments, rising defense spending and orders, and the reductions in inventory already achieved, all tend to support the generally held view among economists that some recovery is likely in the second half of the year.

I am also conscious of the fact that the leveling off of the GNP has masked continuing weakness in important sectors of the economy. In its early stages, the prospective recovery must be led largely by consumer spending. But to be sustained over time, and to support continuing growth in productivity and living standards, more investment will be necessary. At present, as you know, business investment is moving lower. House building has remained at depressed levels; despite some small gains in starts during the spring, the cyclical strength "normal" in that industry in the early stages of recovery is lacking. Exports have been adversely affected by the relative strength of the dollar in exchange markets.

I must also emphasize that the current problems of the American economy have strong parallels abroad. Governments around the world have faced, in greater or lesser degree, both inflationary and fiscal problems. As they have come to grips with those problems, growth has been slow or non-existent, and the recessionary tendencies in various countries have fed back, one on another.

In sum, we are in a situation that obviously warrants concern, but also has great opportunities. Those opportunities lie in major part in achieving lasting progress -- in pinning down and extending what has already been achieved -- toward price stability. In doing so, we will be laying the base for sustaining recovery over many years ahead, and for much lower interest rates, even as the economy grows. Conversely, to fail in that task now, when so much headway has been made, could only greatly complicate the problems of the economy over time. I find it difficult to suggest when and how a credible attack could be renewed on inflation should we neglect completing the job now. Certainly the doubts and skepticism about our capacity to deal with inflation -- which now seem to be yielding -- would be amplified, with unfortunate consequences for financial markets and ultimately for the economy.

I am certain that many of the questions, concerns and dangers in your mind lie in the short run -- and that those in good part revolve around the pressures in financial markets. Can we look forward to lower interest rates to support the expansion in investment and housing as the recovery takes hold? Is there, in fact, enough liquidity in the economy to support expansion -- but not so much that inflation is reignited? Will, in fact, the economy follow the recovery path so widely forecast in coming months?

These are the questions that we in the Federal Reserve must deal with in setting monetary policy. As we approach these policy decisions, we are particularly conscious of the fact that monetary policy, however important, is only one instrument of economic policy. Success in reaching our common objective of a strong and prosperous economy depends upon more than appropriate monetary policies, and I will touch this morning on what seem to me appropriately complementary policies in the public and private sectors.

The Monetary Targets

Five months ago, in presenting our monetary and credit targets for 1982, I noted some unusual factors could be at work tending to increase the desire of individuals and businesses to hold assets in the relatively liquid forms encompassed in the various definitions of money. Partly for that reason -- and recognizing that the conventional base for the M1 target of the fourth quarter of 1981 was relatively low -- I indicated that the Federal Open Market Committee contemplated growth toward the upper ends of the specified ranges. Given the "bulge" early in the year in M1, the Committee also contemplated that that particular measure of money might for some months remain above a "straight line" projection of the targeted range from the fourth quarter of 1981 to the fourth quarter of 1982.

As events developed, M1 and M2 both remained somewhat above straight line paths until very recently. M3 and bank credit have remained generally within the indicated range, although close to the upper ends. (See Table I.) Taking the latest full month of June, M1 grew 5.6% from the base period and M2 9.4%, close to the top of the ranges. To the second quarter as a whole, the growth was higher, at 6.8% and 9.7%, respectively. Looked at on a year-over-year basis, which appropriately tends to average through volatile monthly and quarterly figures, M1 during the first half of 1982 averaged about 4-3/4% above the first half of 1981 (after accounting for NOW account shifts early last year). On the same basis, M2 and M3 grew by 9.7 and 10.5 percent, respectively, a rate of growth distinctly faster than the nominal GNP over the same interval.

In conducting policy during this period, the Committee was sensitive to indications that the desire of individuals and others for liquidity was unusually high, apparently reflecting concerns and uncertainties about the business and financial situation. One reflection of that may be found in unusually large declines in "velocity" over the period -- that is, the ratio of measures of money to the gross national product. M1 velocity -- particularly for periods as short as three to six months -- is historically volatile. A cyclical tendency to slow (relative to its upward trend) during recessions is common. But an actual decline for two consecutive quarters, as happened late in 1981 and the first quarter of 1982, is rather unusual. The magnitude of the decline during the first quarter was larger than in any quarter of the entire postwar period. Moreover, declines in velocity of this magnitude and duration are often accompanied by (and are related to) reduced short-term interest rates. Those interest rate levels during the first half of 1982 were distinctly lower than during much of 1980 and 1981, but they rose above the levels reached in the closing months of last year.

More direct evidence of the desire for liquidity or precautionary balances affecting M1 can be found in the behavior of NOW accounts. As you know, NOW accounts are a relatively new instrument, and we have no experience of behavior over the course of a full business cycle. We do know that NOW accounts are essentially confined to individuals, their turnover relative to demand accounts is relatively low, and, from the standpoint of the owner, they have some of the characteristics of savings deposits, including a similarly low interest rate but easy access on demand. We also know the great bulk of the increase in M1 during the early part of the year -- almost 90% of the rise from the fourth quarter of 1981 to the second quarter of 1982 -- was concentrated in NOW accounts, even though only about a fifth of total M1 is held in that form. In contrast to the steep downward trend in low-interest savings accounts in recent years, savings account holdings have stabilized or even increased in 1982, suggesting the importance of a high degree of liquidity to many individuals in allocating their funds. A similar tendency to hold more savings deposits has been observed in earlier recessions.

I would add that the financial and liquidity positions of the household sector of the economy, as measured by conventional liquid asset and debt ratios, has improved during the recession period. Relative to income, debt repayment burdens have declined to the lowest level since 1976. Trends among business firms are clearly mixed. While many individual firms are under strong pressure, some rise in liquid asset holdings for the corporate sector as a whole appears to be developing. The gap between internal cash flow (that is, retained earnings and depreciation allowances) and spending for plant, equipment, and inventory has also been at an historically low level, suggesting that a portion of recent business credit demands is designed to bolster liquidity. But, for many years, business liquidity ratios have tended to decline, and balance sheet ratios have reflected more dependence on short-term debt. In that perspective, any recent gains in liquidity appear small.

In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregates appeared inappropriate. Such an effort would have required more pressure on bank reserve positions -- and presumably more pressures on the money markets and interest rates in the short run. At the same time, an unrestrained build-up of money and liquidity clearly would have been inconsistent with the effort to sustain progress against inflation, both because liquidity demands could shift quickly and because our policy intentions could easily have been misconstrued. Periods of velocity decline over a quarter or two are typically followed by periods of relatively rapid increase. Those increases tend to be particularly large during cyclical recoveries. Indeed, velocity appears to have risen slightly during the second quarter, and the growth in NOW accounts has slowed.

Judgments on these seemingly technical considerations inevitably take on considerable importance in the target-setting process because the economic and financial consequences (including the consequences for interest rates) of a particular M1 or M2 increase are dependent on the demand for money. Over longer periods, a certain stability in velocity trends can be observed, but there is a noticeable cyclical pattern. Taking account of those normal historical relationships, the various targets established at the beginning of the year were calculated to be consistent with economic recovery in a context of declining inflation. That remains our judgment today. Inflation has, in fact, receded more rapidly than anticipated at the start of the year potentially leaving more "room" for real growth. On that basis, the targets established early in the year still appeared broadly appropriate, and the Federal Open Market Committee decided at its recent meeting not to change them at this time.

However, the Committee also felt, in the light of developments during the first half, that growth around the top of those ranges would be fully acceptable. Moreover -- and I would emphasize this -- growth somewhat above the targeted ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money. We will look to a variety of factors in reaching that judgment, including such technical factor as the behavior of different components in the money supply, the growth of credit, the behavior of banking and financial markets, and more broadly, the behavior of velocity and interest rates.

I believe it is timely for me to add that, in these circumstances, the Federal Reserve should not be expected to respond, and does not plan to respond, strongly to various "bulges" -- or for that matter "valleys" -- in monetary growth that seem likely to be temporary. As we have emphasized in the past, the data are subject to a good deal of statistical "noise" in any circumstances, and at times when demands for money and liquidity may be exceptionally volatile, more than usual caution is necessary in responding to "blips."*

We, of course, have a concrete instance at hand of a relatively large (and widely anticipated) jump in M1 in the first week of July -- possibly influenced to some degree by larger social security payments just before a long weekend. Following as it did a succession of money supply declines, that increase brought the most recent level for M1 barely above the June average, and it is not of concern to us.

It is in this context, and in view of recent declines in short-term market interest rates, that the Federal Reserve yesterday reduced the basic discount rate from 12 to 11½ percent.

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*In that connection, a number of observers have noted that the first month of a calendar quarter -- most noticeably in January and April -- sometimes shows an extraordinarily large increase in M1 -- amplified by the common practice of multiplying the actual change by 12 to show an annual rate. Those bulges, more typically than not, are partially "washed out" by slower than normal growth the following month. The standard seasonal adjustment techniques we use to smooth out monthly money supply variations -- indeed, any standard techniques -- may, in fact, be incapable of keeping up with rapidly changing patterns of financial behavior, as they affect seasonal patterns. A note attached to this statement sets forth some work in process developing new seasonal adjustment techniques.

In looking ahead to 1983, the Open Market Committee agreed that a decision at this time would -- even more obviously than usual -- need to be reviewed at the start of the year in the light of all the evidence as to the behavior of velocity, or money and liquidity demand, during the current year. Apart from the cyclical influences now at work, the possibility will need to be evaluated of a more lasting change in the trend of velocity.

The persistent rise in velocity during the past twenty years has been accompanied by rising inflation and interest rates -- both factors that encourage economization of cash balances. In addition, technological change in banking -- spurred in considerable part by the availability of computers -- has made it technically feasible to do more and more business on a proportionately smaller "cash" base. With incentives strong to minimize holdings of cash balances that bear no or low interest rates, and given the technical feasibility to do so, turnover of demand deposits has reached an annual rate of more than 300, quadruple the rate ten years ago. Technological change is continuing, and changes in regulation and bank practices are likely to permit still more economization of M1-type balances. However, lower rates of interest and inflation should moderate incentives to exploit that technology fully. In those conditions, velocity growth could slow, or conceivably at some point stop.

To conclude that the trend has in fact changed would clearly be premature, but it is a matter we will want to evaluate carefully as time passes. For now, the Committee felt that the existing targets should be tentatively retained for next year. Since we expect to be around the top end of the ranges this year, those tentative targets would of course be fully consistent with somewhat slower growth in the monetary aggregates in 1983. Such a target would be appropriate on the assumption of a more or less normal cyclical rise in velocity. With inflation declining, the tentative targets would appear consistent with, and should support, continuing recovery at a moderate pace.

The Blend of Monetary and Fiscal Policy

The Congress, in adopting a budget resolution contemplating cuts in expenditures and some new revenues, also called upon the Federal Reserve to "reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy." I can report that members of the Committee welcomed the determination of the Congress to achieve greater fiscal restraint, and I want particularly to recognize the leadership of members of the Budget Committees and others in achieving that result. In most difficult circumstances, progress is being made toward reducing the huge potential gap between receipts and expenditures. But I would be less than candid if I did not also report a strong sense that considerably more remains to be done to bring the deficit under control as the economy expands. The fiscal situation as we appraise it, continues to carry the implicit threat of "crowding out" business investment and housing as the economy grows -- a process that would involve interest rates substantially higher than would otherwise be the case. For the more immediate future, we recognized that the need remains to convert the intentions expressed in the Budget Resolution into concrete legislative action.

In commenting on the budget, I would distinguish sharply between the "cyclical" and "structural" deficit -- that is, the portion of the deficit reflecting an imbalance between receipts and expenditures even in a satisfactorily growing economy with declining inflation. To the extent the deficit turns out to be larger than contemplated entirely because of a shortfall in economic growth, that "add on" would not be a source of so much concern. But the hard fact remains that, if the objectives of the Budget Resolution are fully reached, the deficit would be about as large in fiscal 1983 as this year even as the economy expands at a rate of 4 to 5 percent a year and inflation (and thus inflation generated revenues) remains higher than members of the Open Market Committee now expect.

In considering the question posed by the Budget Resolution, the Open Market Committee felt that full success in the budgetary effort should itself be a factor contributing to lower interest rates and reduced strains in financial markets. It would thus assist importantly in the common effort to reduce inflationary pressures in the context of a growing economy. By relieving concern about future financing volume and inflationary expectations, I believe as a practical matter a credibly firmer budget posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears. Specifically, market anxiety that short-run increases in the Ms might presage continuing monetization of the debt could be ameliorated. But any gains in these respects will of course be dependent on firmness in implementing the intentions set forth in the Resolution and on encouraging confidence among borrowers and investors that the effort will be sustained and reinforced in coming years.

Taking account of all these considerations, the Committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have anticipated. Indeed, excessive monetary growth -- and perceptions thereof -- would undercut any benefits from the budgetary effort with respect to inflationary expectations. We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

Concluding Comments

In an ideal world, less exclusive reliance on monetary policy to deal with inflation would no doubt have eased the strains and high interest rates that plague the economy and financial markets today. To the extent the fiscal process can now be brought more fully to bear on the problem, the better off we will be -- the more assurance we will have that interest rates will decline and keep declining during the period of recovery, and that we will be able to support the increases in investment and housing essential to healthy, sustained recovery. Efforts in the private sector -- to increase productivity, to reduce costs, and to avoid inflationary and job-threatening wage increases -- are also vital, even though the connection between the actions of individual firms and workers and the performance of the economy may not always be self-evident to the decision makers. We know progress is being made in these areas, and more progress will hasten full and strong expansion.

But we also know that we do not live in an ideal world. There is strong resistance to changing patterns of behavior and expectations ingrained over years of inflation. The slower the progress on the budget, the more industry and labor build in cost increases in anticipation of inflation or Government acts to protect markets or impede competition, the more highly speculative financing is undertaken, the greater the threat that available supplies of money and credit will be exhausted in financing rising prices instead of new jobs and growth. Those in vulnerable competitive positions are most likely to feel the impact first and hardest, but unfortunately the difficulties spread over the economic landscape.

The hard fact remains that we cannot escape those dilemmas by a decision to give up the fight on inflation -- by declaring the battle won before it is. Such an approach would be transparently clear -- not just to you and me -- but to the investors, the businessmen and the workers who would, once again, find their suspicions confirmed that they had better prepare to live with inflation, and try to keep ahead of it. The reactions in financial markets and other sectors of the economy would, in the end, aggravate our problems, not eliminate them. It would strike me as the cruelest blow of all to the millions who have felt the pain of recession directly to suggest, in effect, it was all in vain.

I recognize months of recession and high interest rates have contributed to a sense of uncertainty. Businesses have postponed investment plans. Financial pressures have exposed lax practices and stretched balance sheet positions in some institutions -- financial as well as non-financial. The earnings position of the thrift industry remains poor.

But none of those problems can be dealt with successfully by re-inflation or by a lack of individual discipline. It is precisely that environment that contributed so much to the current difficulties.

In contrast, we are now seeing new attitudes of cost containment and productivity growth -- and ultimately our industry will be in a more robust competitive position. Millions are benefitting from less rapid price increases -- or actually lower prices -- at their shopping centers and elsewhere. Consumer spending appears to be moving ahead, and inventory reductions help set the stage for production increases.

Those are developments that should help recovery get firmly underway. The process of disinflation has enough momentum to be sustained during the early stages of recovery -- and that success can breed further success as concerns about inflation recede. As recovery starts, the cash flow of business should improve. And, more confidence should encourage greater willingness among investors to purchase longer debt maturities. Those factors should, in turn, work toward reducing interest rates, and sustaining them at lower levels, encouraging in turn the revival of investment and housing we want.

I have indicated the Federal Reserve is sensitive to the special liquidity pressures that could develop during the current period of uncertainty. Moreover, the basic solidity of our financial system is backstopped by a strong structure of governmental institutions precisely designed to cope with the secondary effects of isolated failures. The recent problems related largely to the speculative activities of a few highly leveraged firms can and will be contained, and over time, an appropriate sense of prudence in taking risks will serve us well.

We have been through -- we are in -- a trying period. But too much has been accomplished not to move ahead and complete the job of laying the groundwork for a much stronger economy. As we look forward, not just to the next few months but to long years, the rewards will be great: in renewed stability, in growth, and in higher employment and standards of living. That vision will not be accomplished by monetary policy alone. But we mean to do our part.

Table I

Targeted and Actual Growth of Money and Bank Credit

(Percent changes, at seasonally adjusted annual rates)

	FOMC Objective 1981Q4 to 1982Q4	Actual Growth		
		1981Q4 to June '82	1981Q4 to 1982Q2	1981H1 to 1982H1
M1	2-1/2 to 5-1/2	5.6	6.8	4.7**
M2	6 to 9	9.4	9.7	9.7
M3	6-1/2 to 9-1/2	9.7	9.8	10.5
Bank Credit*	6 to 9	8.0	8.3	8.4

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* The base for the bank credit target is the average level of December 1981 and January 1982, rather than the average for 1981Q4. This base was adopted because of the impact on the series of shifts of assets to the new international banking facilities (IBFs); the 1981H1-to-1982H1 figure has been adjusted for the impact of the initial shifting of assets to IBFs.

** Adjusted for impact of shifts to new NOW accounts in 1981.

Appendix

Alternative Seasonal Adjustment Procedure

For some time the Federal Reserve has been investigating ways to improve its procedures for seasonal adjustment, particularly as they apply to the monetary aggregates. In June of last year, a group of prominent outside experts, asked by the Board to examine seasonal adjustment techniques, submitted their recommendations.[1] The committee suggested, among other things, that the Board's staff develop seasonal factor estimates from a model-based procedure as an alternative to the widely used X-11 technique that provides the basis for the current seasonal adjustment procedure,[2] and release the results.

The Board staff has been developing a procedure using statistical models tailored to each individual series.[3] The table on the last page compares monthly and quarterly average growth rates for the current M1 series with those of an alternative series from the model-based approach.

Differences in seasonal adjustment techniques do not change the trend in monetary growth, but, as may be seen in the table, they do alter month-to-month growth rates owing to differing estimates of the distribution over time of the seasonal component in money behavior. Short-run money growth is variable under both the alternative and current techniques of seasonal adjustment, illustrating the inherently large "noise" component of the series. However, the redistribution of the seasonal component under the alternative technique does on average tend to moderate month-to-month changes somewhat.

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[1] See Committee of Experts on Seasonal Adjustment Techniques, Seasonal Adjustment of the Monetary Aggregates (Board of Governors of the Federal Reserve System, October 1981).

[2] The current seasonal adjustment technique has most recently been summarized in the description to the mimeograph release of historical money stock data dated March 1982. Detailed descriptions of the X-11 program and variants can be obtained from technical paper no. 15 of the U. S. Department of Commerce (rev. February 1967) and from the report to the Board cited in footnote 1.

[3] The model-based seasonal adjustment procedures currently under review by the Board staff use methods based on the well-developed theory of statistical regression and time series modeling. These approaches allow development of seasonal factors that are more sensitive than the current factors to unique characteristics of each series, including, for example, fixed and evolving seasonal patterns, trading day effects, within-month seasonal variations, holiday effects, outlier adjustments, special events adjustments (such as the 1980 credit controls experience), and serially correlated noise components.

The Board will continue to publish seasonally adjusted estimates for M1 on both current and alternative bases at least until the annual review of seasonal factors in 1983. A detailed description of the alternative method will be available shortly.

Growth Rates of M1 Using Current[1] and Alternative[2] Seasonal Adjustment Procedures (Monthly Average - Percent Annual Rates)

	1981			1982	
	Current	Alternative		Current	Alternative
Jan.	9.8	1.4	Jan.	21.0	11.4
Feb.	4.3	7.5	Feb.	-3.5	1.3
Mar.	14.3	16.0	Mar.	2.7	6.4
Apr.	25.2	22.6	Apr.	11.0	4.5
May	-11.4	-10.3	May	-2.4	0.5
June	-2.2	-0.6	June	-1.6	1.3
July	2.8	2.2			
Aug.	4.8	5.3			
Sept.	0.3	3.1			
Oct.	4.7	0.0			
Nov.	9.7	11.1			
Dec.	12.4	15.4			

(Quarterly Average - Percent Annual Rates)

QI	4.6	3.5	QI	10.4	9.5
QII	9.2	9.6	QII	3.1	3.4
QIII	0.3	0.9			
QIV	5.7	5.5			

1/ Current monthly seasonal factors are derived using an X-11/ARIMA-based procedure applied to monthly data.

2/ Alternative monthly seasonal factors are derived using a model-based procedure applied to weekly data.

The **Chairman**. Thank you, Chairman Volcker.

Mr. Chairman, the discount window has remained a very mysterious element of the Federal Reserve's operations. Unfortunately, by law it is excluded from even any auditing by the GAO. As I recall, in 1977 when the GAO auditing of portions of the Fed came about, that there were those of us who agreed that we would revisit this exclusion at a later date, and perhaps the time has come for such a revisiting.

However, once again the spotlight is seeking out the discount window operation in the Penn Square Bank failure in Oklahoma. One wonders how much money the Fed put into the bank for the 12 months prior to July 6 when it was declared a failed bank and shut down.

Next, who made the decision to toss a series of liferafts to the bank during those months? Do you think that the Federal Reserve's open window policy gave a false sense of security to private investors who placed money in the bank while your life support systems were in place? Now, of course, we read about another bank, the Abilene National Bank of Texas. There are some news reports that it has received $30 million, others $50 million, depending on which news story is to be believed.

Once again, who makes the decision that this is a worthy use of funds dispensed by a public agency? Overall, what does the free use of the discount window do? And this is questionable in the minds of some, what does it do for market discipline, for the market discipline of financial institutions?

So to run through it again, who made the decision? Do you know how much was pumped into, or can you tell us, Penn Square? And do you think that this gave a false sense of security to many of the investors who are caught with their deposits over $100,000?

Chairman **Volcker**. I don't think there is anything mysterious about the operations of the discount window, Mr. Chairman. I am a little bit disturbed to hear your characterization. We do not, and obviously cannot, comment in terms of our lending to individual, ongoing institutions. But in the case of Penn Square, I think I can tell you there was no borrowing at the discount window in the year prior to the demise of that institution until 3 working days before the actual closure of the bank.

We did lend some money on the Wednesday and the Friday before the closing, $20 million one day, and after this loan was paid off on Thursday, the next day—Friday—a little under $6 million. But there wasn't any borrowing in the previous year. There had been some borrowings intermittently in earlier years by that bank but none in the previous year.

The **Chairman**. The lending within 3 days of the closure, was that perhaps an effort to see if other arrangements could be made to avoid the drastic action that was eventually taken?

Chairman **Volcker**. There was a run on the bank for a perfectly normal reason. In fact, the basic reason the discount window is there in the first place is to provide credit under those circumstances if that can be done safely and soundly. These loans, of course, were fully secured, and certainly it is preferable to lend money on secured bases in that period, while you see what needs to be done with the bank, indeed whether it has to be closed at all.

We are prepared to lend to banks that are under liquidity pressures in circumstances of that kind; that is our function.

The **CHAIRMAN**. And in the case of Abilene National Bank?

Chairman **VOLCKER**. I do not want to comment on individual operating banks. A bank that is in a functioning position, experiencing a loss in deposits, if it has adequate collateral, certainly has the discount window available to it.

The **CHAIRMAN**. When you say adequately protected, are you stating that in the case of the $26 million that was lent to Penn Square——

Chairman **VOLCKER**. That was not the total; it was $20 million on one day, Wednesday, and $6 million on Friday.

The **CHAIRMAN**. Right. So the $20 million on that occasion right at the very end, but that is secured and have been repaid or will be repaid in full?

Chairman **VOLCKER**. I do not know just what the situation is now. We will certainly be repaid in full, yes. Whether we have been repaid yet or not, while the thing is in the process of liquidation, I do not know.

The **CHAIRMAN**. Repaid after liquidation? In other words, do you occupy a preferred position?

Chairman **VOLCKER**. Yes. We are secured and we have a preferred position.

The **CHAIRMAN**. Preferred position over depositors who had funds in there over $100,000?

Chairman **VOLCKER**. Yes, we have our loans fully secured.

The **CHAIRMAN**. That means that an institution, whether this $20 million had gone in 2 days before the failure or 6 months before the failure, nevertheless the moneys are advanced or lent that are fully secured, and then other private investors not aware of—and this is a big problem, the secrecy—not aware of the fact that a particular institution is suffering or is on a problem list or is very close or on the brink of failure. They keep putting money in but they are not protected. Yet the Fed's injection of funds gives the appearance to the public at large that that individual or particular institution is indeed healthy.

Chairman **VOLCKER**. I don't think——

The **CHAIRMAN**. Is that not a problematical thing?

Chairman **VOLCKER**. The public at large would not know about the lending operation at the time.

The **CHAIRMAN**. Exactly. Therefore, the institution continues to function with an artificial infusion of funds and the public at large is not aware of the fact that that is taking place.

Chairman **VOLCKER**. You call it an artificial infusion of funds. At its very foundation the Federal Reserve System was designed to assist institutions that are facing a liquidity situation of this sort. I think there is an expectation in the Congress as well as elsewhere that those loans will be secured when we make them.

The **CHAIRMAN**. Oh, sure.

Mr. Chairman, my time has expired, although my staff did not give me the 5-minute notice, and they better start doing it in all fairness to all the members. I think this is an item that we are going to have to pursue further. I do not want to take up any more of the committee's time on this at this point, but I think that we are not communicating or thinking in the same direction but I think we eventually shall if we were to pursue it a little further.

Mr. Stanton.

Mr. STANTON. Thank you very much, Mr. Chairman.

Mr. Chairman, it is now history of course that the Board has decided to retain the current target ranges for monetary aggregates for 1983. Many people, of course, would have liked to have seen these ranges raised, I expect particularly for M_1. Certainly this was an option which the Board must have discussed in considerable length before it came to the conclusion to keep the same targets.

What would you say was the biggest reason that the Board concluded that now was not the time to raise its target ranges?

Chairman VOLCKER. Options of increasing or decreasing the ranges were discussed. We say this, I suppose, every time we come up here in midyear and are asked to give a range extending 18 months in advance; that is, that there is a great deal of uncertainty. We genuinely feel that there is more uncertainty than usual this time because of some question about where the trend in velocity is going.

There are two offsetting considerations here. One is that we can look at the trend in velocity through the years of 3 to 4 percent. We just presumed that that continued—and would be higher than the trend during a year of recovery that we would expect 1983 to be—and this range seemed to provide enough room for achieving our objectives.

Now you can also argue that technology is speeding up, and that velocity may increase even faster for some of the reasons that Mr. Fauntroy and others, I am sure, have in mind in their statements about M_1. On the other hand, while I think it is premature to make the judgment, I think the general case can be made that a declining inflation rate and declining interest rates will tend to slow the increase in velocity. If we felt strongly that would happen at this point, that would be the main case, I think, for raising the target level. If you assume that velocity growth—to put it in extreme terms—is going to slow to zero, then you would have some question about raising those targets. We are not ready to make that judgment yet. We do not have the evidence for it. Therefore, we decided, in this somewhat uncertain situation, that keeping the target unchanged as a tentative action conveyed the right signals about our policy posture of continuing concern about not providing too much money in terms of the inflationary outlook, but enough to permit and encourage recovery to continue.

Mr. STANTON. On page 15 of your testimony you stated:

> I believe as a practical matter, a credibly firmer budget posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears.

Could you describe for us what you really mean by a credibly firmer budget posture? Are you referring to the fact that we passed a budget and we are now in the reconciliation stage?

Chairman VOLCKER. I really have two things in mind, Mr. Stanton. One is that you passed a budget resolution, and you are now in the stage of implementing that resolution in legislative action. I must say that I welcome the budget resolution because I think it shows progress in dealing with the budgetary situation.

But I would not want to leave you with the impression that that is the end of the story, even if the resolution were perfectly implemented. Even assuming the growth in the economy, even assuming the inflation rate underlying that resolution, it leaves us with a budgetary deficit that would be as big next year as it is this year and, as things now stand, with somewhat more problematical declines in future years.

Among other things, our best estimate is that the inflation rate will be lower than the assumption used in that budget resolution. To the extent the inflation rate is lower, which is a good thing, it will be reflected in a budgetary outcome of more deficit, rather than less, because we will not have the inflationary revenues.

I do not want to leave the impression that, even with full implementation of the budgetary resolution—which I do welcome—the fiscal problem is behind us. All I mean to convey by that statement in my testimony is that the more progress that is made—first of all, in implementing the resolution, but second, in conveying the impression and actuality, conveying that credibly, that that is a step in a progress toward reducing deficits—the more assurance I think the world at large and the financial markets in particular will have that monetary policy is not going to have to cope with inflationary impulses or market pressures arising from the budgetary side of the equation. That means, I think, a little less sensitivity on the part of the market to every wiggle in the monetary figures.

Mr. STANTON. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Reuss.

Mr. REUSS. Thank you, Mr. Chairman.

Mr. Volcker, I will now ask the two questions which I telegraphed a moment ago. Question No. 1: You, in the Federal Open Market Committee, projected a nominal growth rate for 1983 of 7 to 9.5 percent, and you proposed to finance that with 2.5 to 5.5 percent new M_1. If, despite your hopes, interest rates go up, are you prepared to relax your monetary targets?

Chairman VOLCKER. I would not look at interest rates alone; I would look at the variety of indicators that I mentioned in my statement. As I indicated, if in our judgment there are extraordinary liquidity pressures, extraordinary demands for precautionary balances, we would take that into account.

Mr. REUSS. Well, what about extraordinary unemployment, extraordinary bankruptcy and extraordinary high interest rates? Do you take those into account?

Chairman VOLCKER. All those things enter into that judgment, but I would not want to look at any single indicator.

Mr. REUSS. My second question had to do with your decision to technically keep the 2.5- to 5.5-percent M_1 range but to make as your actual target the very top of that, 5.5 percent, and even to say that you may want to go over that. If I had been on the Open Market Committee, I would not have objected to the 5.5-percent target that you have adopted, coupled with its "if we go over it, do not worry," but I certainly would not have practiced what I regard as brinksmanship by picking the very top of your range as your actual target.

Why in the name of commonsense did you not say that your target is 4 to 7 percent, with the 5.5 percent in the middle? Then, if as human beings will, you err a bit, you do not drive the markets up a wall as you have been doing for many months now. If I had been there at your deliberations and presented that point of view, what would your answer have been?

Chairman **Volcker**. I think our answer, as a committee, is that we thought this choice more accurately reflected our intentions.

Mr. **Reuss**. That begs the question, though. What would you have told me? I would have been quite persistent and demanded a reason.

Chairman **Volcker**. Because we do not think, as we now see things, that we want 7 or 7.5 percent at the top of your hypothetical ranges.

Mr. **Reuss**. I said 4 to 7 percent, of which 5.5 percent, which you have said is what you want, is the exact middle.

Chairman **Volcker**. I did not remember if you said 7 or 7.5 percent; let us say 7 percent. It would have been interpreted, I think, as a willingness of the Federal Reserve to look upon 7 percent as a likely and desirable outcome. Looking at all evidence now, we think it is unlikely.

Mr. **Reuss**. If I could interrupt you there, you could have readily dispelled that false notion on the part of the market by having everyone, including myself, the assumed proposer of the motion, say no, we are shooting at 5.5 percent but we do not want to be in the position, as we lamentably have been in the position for many months, of overshooting our ranges. I do not think any sane market observer would have been flummoxed by that sort of statement.

Chairman **Volcker**. I do not know; you might say that. It was our judgment that we were more accurately conveying our intentions by saying what we did. Obviously we could have picked different ranges, but we thought that this was the best way to convey our intentions.

Mr. **Reuss**. Well, I will make you a little friendly wager. For every qualified market observer that you can produce who will testify that he would have been panicked by you saying we are going to shoot for 5.5 percent with a 1- or 1.5-percent margin for error on either side, I will produce four people who will say that practicing brinksmanship, saying we are going to give a range and half the time be over it, would produce, as it has produced, very real market distortions.

Chairman **Volcker**. I think we have conveyed a somewhat different impression. We say we are aiming at around 5.5 percent, that we can conceive of conditions in which, for a time, we might run above that. That conveys a somewhat different impression than saying the range is itself up to 7 percent, and that may be without those special conditions we would be up there.

You and I both know that money cannot be controlled with that degree of precision, at 5.5 percent or 5 percent or whatever; we can't hit it on the nose.

Mr. REUSS. Well, my time is up. I would conclude by saying that I wish the Federal Reserve in its future responses to the congressional mandate would tell us what its actual target is. Do not give us a range and then dart above that range. That confuses Congress, it confuses markets, and it means that even if you do provide enough new money, you do not get the benefits of it because investors are very nervous.

Chairman VOLCKER. I have to disagree with that approach. If I may say so, Mr. Reuss, I think just giving a single figure——

Mr. REUSS. And a range.

Chairman VOLCKER. I thought you were saying we should not give a range.

Mr. REUSS. Specifically what I say is in the present circumstances, since you have told us 5.5 percent is what you want, I say you should have given us a 4- to 7-percent range so that if you fail to exactly hit your target, you do not alarm people.

Anyway, those are my views, and I guess we disagree.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

Chairman Volcker, as you pointed out, you are walking a very fine line in terms of your flexibility. Our most serious problem by all accounts is high-interest rates. We need strong medicine, and apparently we are not going to reduce spending very much in the short term given the realities vis-a-vis the entitlement programs, defense spending and so forth.

So I would ask two questions together. One, do you think deferring the third year tax cut would reduce interest rates? And two, if you were a Member of Congress, not that you would want to be, but if you were, would you favor putting off the third year tax cut?

Chairman VOLCKER. My general feeling is that I certainly want to see some more action to reduce the deficits in coming years. I do not think that that particular technique is the best way of going about it. Preferably, you would reduce expenditures, or you would look to other forms of revenue raising. But I do not think things hinge, in any analytic sense, on the third year of the tax cut; that is much more of a political question.

I am glad I am not in the Congress. Quite often you have to decide on those kinds of questions. But I would rather put my emphasis on the need for further fiscal actions. The revenueside, economically, is probably not the most desirable way to achieve the deficit reduction, but you have to consider what other options you have.

The CHAIRMAN. Would the gentleman yield for half a second?

Mr. WYLIE. Yes.

The CHAIRMAN. The bells have rung for a record vote. At the end of Mr. Wylie's questioning, we will recess for a vote and immediately return.

Mr. WYLIE. Thank you.

Mr. Chairman, this is a critical time in the election cycle, as you mentioned, and I want to compliment the Federal Open Market Committee for not bowing to political pressure in your instance, but we have to take account of political realities. On other occasions you have set a substantial boost in the reserves, in the monetary reserves. To increase the growth of the M_1 would have a perverse effect in the bond markets and would result in Government bond markets falling and interest rates would increase because investors would anticipate renewed inflation.

The economy has deteriorated since you first made that statement in February before this committee. Now, do you still feel that that would happen?

Chairman VOLCKER. It is always a matter of judgment in any particular situation, Mr. Wylie. We have made some progress, and reinforced the progress, on inflation. The economy is in recession. Quite clearly, those two events bear upon the answer to the question to a matter of degree; and the question you are asking is a matter of degree.

Yes, I think that if the markets thought that we were, to put it in simple terms, giving up on inflation—we were ready to see some reinflation—you would get an adverse effect on interest rates. If it is clear that that priority has not been given up at all, we would get a different reaction. In specifics, that comes down to a matter of judgment.

Obviously we believe that the kind of policy we have outlined in the statement does not and should not carry the threat of rising interest rates from excessively easy policy, but that could happen if there were a different interpretation.

Mr. WYLIE. This whole area is highly technical. I would say on page 24 and 25 of the Federal Reserve Board's midyear report they make reference to the velocity of money necessary to fulfill the forecasts of the Federal Open Market Committee. Mr. Stanton has made reference to this and you made reference to it in the Wall Street Journal article of today before the Senate Banking Committee. For 1982 a velocity characteristic of the early stages of recovery is specified in that report, and for 1983 a "relatively high" growth in velocity is required.

Now, could you put this matter in perspective for us for the record or by the submission of charts and tables for further explanation? Can you assure us that relatively high growth in velocity for 1983 does not lead to unprecedentedly high growth in velocity for 1983? And what impact does a rise in velocity have for inflation, money growth, and interest rates?

Now, those have been touched upon, as I said, ancillarily, but you rather passed over them, it seems to me.

Chairman VOLCKER. You have to look at velocity, of course, in conjunction with what the money supply itself is doing. It is the product of the two, basically, that is related to the nominal GNP. Note that in the post-war period over the first four quarters of expansion the average growth in velocity has been over 6 percent. It was particularly large in the first post-war recovery. Perhaps that figure is between 5 and 6 percent in the first year of recovery when velocity tends to be particularly fast.

Velocity has been particularly slow in the last two or three quarters. Again, it is a matter of judgment as to whether that says that during the recovery velocity will be higher than usual or whether that is indicative of a change in the trend. I think our range for next year allows ample scope for differences in judgment on that point, but we will look at it again at the end of the year in the light of what has happened.

If we went through the rest of this year without a rise in velocity, we would certainly look at that question again.

Mr. **Wylie**. Thank you very much.

My time is up.

Mr. **Reuss** [presiding]. We will now stand in recess for about 3 minutes.

[Recess.]

The **Chairman**. The committee will come to order.

Mr. Gonzalez.

Mr. **Gonzalez**. I ask unanimous consent to submit in writing questions that would call for some statistical information that I believe would be in the public interest and up to date.

The **Chairman**. Without objection, so ordered.

Mr. **Gonzalez**. I will ask at this time: With reference to something you, Mr. Chairman, started out on the discussion of the impact or the consequences of the Penn Square failure.

On page 18, Mr. Volcker, you said:

> I have indicated the Federal Reserve is sensitive to the special liquidity pressures that would develop during the current period of uncertainty. Moreover, the basic solidity of our financial system is backstopped by a strong structure of governmental institutions precisely designed to cope with the secondary effects of isolated failures.

I have assumed you referred to these institutions such as FDIC, FSLIC——

Chairman **Volcker**. And the Federal Reserve.

Mr. **Gonzalez**. And the Federal Reserve. But from the newspaper accounts I gathered that your sensitivity to the special liquidity pressures were quite sensitive to the development of the Penn Square and its implications. But do you consider this solidity that solid when, as I understand it, the total available resources that the FDIC has would be at the most about $15 billion, whereas you have better than $1 trillion in deposit resources covered. In the case of FSLIC, if I remember correctly, it is a little better than $1 billion in resources and about $600 billion to be covered.

Now the American people, they are very much ahead of us. They are aware. I don't know exactly the resources of the Federal Reserve, but I think you will agree they are not unlimited—was that then the thought that the Fed had some impact in the decisions made immediately upon the obvious failure and the need for liquidation of the Penn Square?

Was that not only one of the contributing factors in the decision to change policy a little bit? Is it true that it did have that kind of an impact? Are you in a position to discuss this?

Chairman **Volcker**. If the implication of your question is that the resources available to the FDIC or the Federal Reserve have been impacted by that decision, in terms of the totality of the resources and the drains on that fund, I do not think that that was a consideration. I think the resources of the FDIC are quite adequate to take care of any contingencies that I could foresee.

The complications in that Penn Square situation were of a different character. It was an extremely complicated problem, partly because of the very large contingent liabilities of the bank involved, in all its loan participations and other activities. There were apparently enough irregularities within the bank and in its accounting and other procedures to raise questions that would not ordinarily be raised in a situation of that sort.

All these things made it more than ordinarily difficult to handle. I think there is a presumption in cases of this sort of working toward some solution other than liquidation of the institution. It is a rare case when that cannot be done, but this was an instance where it could not be done, in the time available at least.

Mr. GONZALEZ. I think the question that was raised even in newspaper accounts is how many Drysdales—how many Penn Squares are there out there in this wild blue banking yonder?

Chairman VOLCKER. Obviously nobody knows the answer to that question, but I do consider these——

Mr. GONZALEZ. Then the regulatory process is not that solid.

Chairman VOLCKER. When you talk about Drysdale, or this Comark firm recently, in that area there is not even regulation or supervisory surveillance over the situation. The firms operate in a market area where you do not have that kind of surveillance, so no one can answer that question precisely.

Do not forget the Penn Square Bank had become reasonably large in the past couple of years and had grown very rapidly, but was still not a very large bank in the general context. Those other firms were very small firms. The basic point I would make is that I think those situations can be viewed as isolated and containable.

Mr. GONZALEZ. Just one followup. Cannot this also be said of this burgeoning thing known as the money market phenomena in the nonregulatory jurisdictional sense?

Chairman VOLCKER. They are not quite the same as these other security firms. They do come under the regulations of the SEC and they have very defined and typically conservative investment practices. So while they are not under banking supervision—which I think creates some problems of competitive equality and the like—they are not unsupervised entirely or without any surveillance.

Money market funds are, in concept, relatively simple operations. They take in very short-term money and they lend money very short term. Their solidity, of course, depends upon just where they invest the money, but I think typically their investment practices have been conservative and mostly short term; they have to be short term to meet the SEC requirements in accordance with their prospectus.

The CHAIRMAN. Mr. McKinney.

Mr. MCKINNEY. Thank you, Mr. Chairman.

Mr. Volcker, I would like your opinion on one of the things that has me disturbed: weekly reporting. Obviously the fluctuation in M_1 is going to show up far more severely on a 7-day basis than it is averaged out over 30 days or 90 days. And what I see, and I hate to say this about my constituents, is a sort of massive M_1 hysteria that sets in on Wall Street every Monday.

It would seem to be far more advisable if we reported M_1 on a 30-day basis averaged out.

Chairman VOLCKER. Basically yes, I agree with that. The Federal Reserve made a policy decision a couple of months ago to publish M_1 on a moving average basis, which dampens some of these swings. I am somewhat embarrassed that that decision has not been implemented yet, for what I can only describe as technical reasons.

The suggestion was made that we compute a new seasonal pattern on a moving average basis and computing that seasonal pattern seems to be beyond——

Mr. McKINNEY. Beyond the computer?

Chairman VOLCKER. Beyond the power of our minds or computers, so apparently we will have to do it within the seasonal adjustment procedure—and we will do that. That still leaves a weekly publication, but on a somewhat smoothed basis.

I would be, I think, happier if we only published monthly. But we do collect the data weekly and the data essentially flow out of operational needs in computing reserve requirements. There is a presumption, I think, rightly or wrongly—that some people would argue is embodied in law—that if we have the statistics, we have to publish them.

Mr. McKINNEY. Well, you know maybe one of your legal experts could tell us what the impediment is. I think it is an important issue and I think we should take a harder look at it.

Mr. NEAL. Would the gentleman yield?

Mr. McKINNEY. Yes.

Mr. NEAL. I understand the gentleman's concern and I agree with him that we should not pay so much attention to these weekly figures. But the argument has been made that sophisticated investors have a way of getting this information anyway and if this data was not published then there would be an advantage to sophisticated investors in the market that would not be available to everybody else.

Mr. McKINNEY. I would like to reclaim my time. I agree with the gentleman. Unfortunately, I think the unsophisticated investor is bobbing in and out like a cork.

The other question I want to ask, which is near and dear to the chairman's heart, deals with credit control. With the problems in the Middle East, with the problems in Asia, and with Third World nations, and Eastern European nations defaulting on their interest and their loans, don't you think that it would be advisable to have a credit control law on the books so that the President could use it should there be some major crisis rather than having to wait for Congress to come back and react at the time?

Would it not be better to have it back on the books so that it is available at any given time should the President need it?

Chairman VOLCKER. I recognize that argument. But on balance and based on experience, it is my judgment that leaving that on the books—with the presumption that it implies that it might be used in less than extremis and the pressures that would arise to use it, perhaps in the Halls of the Congress as elsewhere—would on balance lend more uncertainty to the situation rather than the reverse.

I do not think that tool is basically a useful one, in almost any circumstances which one can foresee, and I think there is some real disadvantage in having it on the books. Among other things, I discovered that at the time we did use that power. We used it in a very limited way when the President so authorized in 1980, as you remember.

It is an enormously sweeping grant of authority. That law could be used to control the American economy very closely if someone were so inclined.

Mr. McKinney. I am assuming, although I do not have any company on this side of the aisle that the President would only use it under the worst of times.

My time is up, but I would just like to ask one more question to follow up on what Mr. Reuss said. I am not going to argue about your target, but it would seem to me that if your target were broader and not operating within too narrow a target range you would not need to have the outrange, broader range.

We would not have the in and out of the target area problem we have with your weekly reporting. I know what you said to Mr. Reuss, but I am a little curious as to what the result would be.

Chairman Volcker. There are competing considerations. I have sympathy for your point, but I would make two points.

I want to have some breadth in the target range and I want to have more than one target, because any one of them can betray you in this very uncertain world. I think you need a cross-checking among various indicators of policy. I both understand and, to a considerable degree, share the thrust of your point.

The argument, of course, on the other side is that if the ranges are too broad they do not give a sufficiently precise indication of where we really intend to be.

We have to reach some compromise between those objectives, but it is, in the end, a quantitative question. I understand your point and appreciate it.

The Chairman. Mr. Fauntroy.

Mr. Fauntroy. Thank you, Mr. Chairman.

Mr. Volcker, I am very much concerned about the equity and fairness of our current anti-inflation policies, especially as they affect black people and other minorities in our country. Last month, the unemployment rate for black workers was 18.5 percent, and unemployment for black teenagers is at 50 percent, and for black male teenagers it is nearly 60 percent. Now that is nearly three times the unemployment rate for white male teenagers. You and I know that black people have, to a large extent, been employed in the low-wage jobs and the wage increases have been, at best, modest. Yet it seems clear that the black community is paying the highest cost for the reduction in inflation. Our adults are losing their jobs and our teenagers are failing to get the valuable work experience that they will need as they become adults.

My questions to you are, first, are these costs inevitable or could some alternative anti-inflation program, including a tighter fiscal policy and an incomes policy, produce the same reduction in inflation without punishing black people so much? Then, second: Has the administration done anything to bring about a fairer anti-inflation effort or to reduce the unemployment costs of this program?

Chairman Volcker. In a general sense I do not think the costs are inevitable to the degree that we are experiencing them, if you consider all the possible instruments of policy. Your question quite correctly opens up that area; we are not just talking about monetary policy.

I think some cost, some pain in the short run, was probably inevitable in dealing with this entrenched inflation. We are then talking about a matter of degree. I think the pain, in a sense, is justified by the long-term rewards. We had a deteriorating economic situation very much related to the accelerating inflation in the 1970's, with an upward trend in unemployment and all the rest which did not help the blacks or others. That is the basic problem we are trying to deal with.

You raise the question of how those costs can be minimized by a different policy mix. I certainly believe that the fiscal side is not centered on financial markets and the fallout from that side of the equation.

When you get to what you term incomes policies, there are a lot of interesting questions. I am skeptical, based upon experience—perhaps more than skeptical—of the workability of the kinds of income policies that we have had here and, to a very large degree, in other countries in the past. At the same time, I do not want to express happiness about all the structural characteristics of the labor market and of the American economy.

I do believe that, looking abroad—and they all are in a different setting, including a different cultural setting, which has an important bearing on this—some countries have relationships between management and labor or tripartite relationships such that it seems to be easier to reach a consensus as to actions, including action on the wage-price front, which are more compatible with keeping prices stable and make it easier to live with appropriately restrained monetary policies.

We have an institutional practice of 3-year wage agreements, coming at different times in different industries. There is a kind of "follow the leader pattern" which I think tends to spread out and delay the adjustments that are necessary in the end and make some of the costs to which you refer higher.

In other countries, there is an annual bargaining cycle that is fitted more closely to some discussion of what appropriately can be borne by the economy over a period of time, and there is some indication that works a little better.

Putting it in that context, I think, also illustrates the difficulty. You're talking about some rather deeply ingrained matters of national approach and behavior. I would like to see more thinking in this area, to see where the changes can be made. I do not see it as promising at this stage to try to have, in effect by governmental edict, a guideline, enforced or otherwise, about what wage increases should be. I do not think that has, in and of itself, been a particularly promising and helpful approach.

Mr. FAUNTROY. I see my time has expired. Thank you.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Mr. Chairman, I would like to return briefly to the Penn Square situation from a little different perspective. It appears to all that have looked at it that it was a bank operated in a unique way and it was probably an aberration. But what was not an aberration is that it seems that a number of rather weakly capitalized money center banks have placed such an emphasis on growth that their participation in Penn Square loans might amount to speculative financing.

My concern is that as you lower the discount rate, which I think most of us support, are you going to put any standards for bank applications to the discount window? For example, you have led the Congress in stressing that we should be lowering our deficits. Should you not now be leading the banking community in stressing that they should be strengthening their capital base and saying that access to the discount window will only be available to those banks that provide greater equity financing for their own institutions?

One aspect of the whole financial community today appears to be an enormous emphasis on growth, unmatched by an emphasis on strengthening capital bases. Will this be a criteria for Fed window access and an emphasis in general on your part?

Chairman VOLCKER. I understand your question very well, and I agree with the thrust of what you're saying. Putting it in a wider context, I think the kind of behavior patterns that you saw in industry or labor—the banking counterpart of that was an aggressive lending posture—grew from living in a world of inflation, where you can get bailed out from some of these things. I think that mood has changed. But I accept, not the technique by which you suggest that it be implemented, but the idea that the regulatory authorities and the Federal Reserve in particular do have a responsibility for encouraging, insisting—whatever words you want to use—that the capital position of those banks, where it appears to be on the low side, is indeed strengthened and that other aspects of their balance sheet or funding are strengthened over time.

I do not think the discount mechanism is a particularly good instrument for doing that, but it is certainly a factor that we want to take into account in the applications and approvals process.

Mr. LEACH. Let me raise it in one other way. You have also expressed some concern in the past about large extensions of credit for merger purposes. Many of us believe that mergers represent the concentration of ownership rather than the creation of new jobs. So here the question is, what pressure can you apply to banks that seem to be involved in excessive revision of credit for mergers?

Is providing or refusing to provide access to the discount window an appropriate technique to influence bank decisions in this area? If not, what techniques do you have? Clearly, simple expressions of opinion do not seem to be making a great deal of difference, because the banks are getting larger on the assets side but not on the capital base side. And the question is, if not the discount window then what?

Chairman VOLCKER. I think you have a different set of problems there. The first area that you raised goes to the traditional questions of safety, soundness and prudence, where we have a clear responsibility. It involves matters of judgment, but I think it fits in with our clear responsibilities.

In the case of merger financing, you and I might have reservations about some of these, based sometimes on inadequate facts and individual situations, but nonetheless raising questions. What should we do about them, if anything? Each one of those cases involves a precise judgment, presumably, in our case, on the basis of the national interest. Is it worthy or unworthy? Is there any real reason for objecting or not?

That is not an area in which we have the competence to inject ourselves, except in very extreme situations. I do not think the Federal Reserve can be the judge and jury as to the economic or other validity of particular merger propositions.

The impact of those mergers—while I may have some questions in my mind as I read the newspaper, as I am sure you do—I do not think is major on the total availability of credit in the country. The activity has to be looked at in the context of an individual bank's position, and would be only one factor in its total loan or liquidity or capital judgment, and we would not have any basis for criticizing such activity if it is in the context of a well-managed, well-functioning, soundly financed bank.

Mr. LEACH. Thank you. My time has expired.

The CHAIRMAN. Mr. Neal?

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Chairman, I would like to ask you to comment on several questions, if I may. If you would, let me state the questions, because I am afraid if I do not I will run out of time before I am able to state them. And I am not asking you for a long dissertation, but I would like to cover these points.

Many people from within the Congress and from the public and from the administration are urging you to start pumping out money to achieve faster rate of growth. In my opinion, if you did that, interest rates would go up, not come down. I would just like to get your comment on that.

Also, recent newspaper reports—and I have read several on the business pages of very excellent newspapers—have indicated that you are easing monetary policy at the very time that, say, the M_1 rate of growth will be reported down $2 or $3 billion. Would that not be an inconsistent reading of the data, to say that you are easing money growth at the same time M_1 is reported to be down for the week?

There has also been some concern raised about the long-term relationship between M_1 and inflation, the idea being that we might find a better correlation between some other measure of money and credit and the predictability of inflation. As I look at the data, I have never seen a better predictor than M_1. Has not that relationship remained fairly constant, and is it not probably the best predictor of inflation?

And finally, I am frankly at a loss to understand why interest rates remain high. We have a real rate of inflation, as I understand it, of 6 percent or so, and yet the prime rate remains high. I could understand it better concerning short rates than long rates.

You have pursued a restrained course for 3 or 4 years now, and I just wonder what it is going to take to convince investors that you are serious. Honestly, I cannot understand that historically high persistent spread between the real rate of inflation and interest rates. And I would appreciate your comments.

Chairman VOLCKER. Let me try to comment on each of those questions in the time we have available.

The CHAIRMAN. About 2½ minutes.

Chairman **Volcker**. Is that my time or Congressman Neal's time?

In terms of pumping up money would interest rates go up, I think I had a little colloquy with Mr. Wylie on that earlier. It depends upon the circumstances, it depends upon the degree. I certainly agree with you, if there were the actuality or indeed the perception that we were now giving up on inflation and launching on an inflationary policy, then I think you would get that adverse effect, which would not do anybody any good.

The difficult judgment that we have to make is that we also respond to liquidity needs and so forth, and make that judgment about what money supply is adequate in these circumstances and does that carry that danger. We are in the process of doing that. And I agree with your basic point, that if we pump out too much, interest rates will go up and it will do us harm, rather than good.

Are we easing monetary policy when M_1 is going down? I don't think we are going to solve these semantic questions here in less than 2½ minutes. We run into the wall of time.

In the sense of looking at the aggregates over a period of time, I think it is correct to say there is no easing there; the monetary aggregates are coming into line. If you look at it in a more technical market sense, you see relief that follows from that phenomenon on bank reserve positions. That relief is reflected in short-term market interest rates which accompany the decline in the money supply.

"Easing" is a term which is used to describe that phenomenon, but it should not convey the impression of pumping up the money supply as suggested by your first question.

Is there a better measure than M_1? My short answer to that would be, I do not want to put all my money on any single measure; I think we have to look at several. M_1 has been pretty good; it is probably as good as any over the years. But we may be in a period, as I discussed in my statement, where in the short run because of the recession and recession uncertainties, and in the longer run because of the very success in fighting inflation, some of those relationships may be changing.

There will continue to be a relationship, but you have to evaluate the change in the relationship and therefore you have to look at other indicators in addition to M_1, I would say.

On your final question, we will never be able to deal with it in however many seconds we have left here. But let me say that I think there are a lot of factors contributing to high interest rates. Yesterday one of the Senators said that it added up to a kind of a "gridlock." In a situation of gridlock things can get unlocked rather suddenly at times. But I would tick off some of the factors.

There has been a very heavy burden on monetary policy alone, on monetary restraint and restrictions in the money supply to deal with the inflationary problem. If that disproportionate burden is put on monetary policy in the short run, you will have more pressure on interest rates than otherwise.

That is related to the fiscal problem—using just a good old supply and demand analysis—the prospects of very high continuing demands from the Treasury.

On the expectational front—which at least in the textbook sense you would expect to be more influential on long-term rates than short-term rates—I think expectations toward inflation are changing, but there is still a lot of skepticism. When you are buying a longer term security you are making a bet on what people think about inflation and what inflation will be, not just over the next 6 months or even during the economic recovery, but over a large number of years. We have not revolutionized expectations.

Another aspect of that is that interest rates have been on a rising trend for 15 years. They have reached extraordinarily high levels. They have been quite volatile. I think that background creates hesitancy among people in making that bet on the long-term markets, even when those rates look highly attractive on the basic grounds of economic analysis, in my opinion.

The CHAIRMAN. The time of the gentleman has expired. Mr. Evans? Mr. Evans? Dr. Paul?

Mr. PAUL. Thank you, Mr. Chairman. Mr. Volcker, I have a few questions relating to the Penn Square Bank, and with the certificates that have been issued. Do we know the amount of these receiver certificates that have been issued in light of the failure of the bank?

Chairman VOLCKER. My understanding is that very, very few receiver certificates have actually been issued so far, in terms of actual pieces of paper delivered into the hands of a depositor.

Mr. PAUL. Is it correct to say that these certificates, then, will be—that you could discount these at the discount window?

Chairman VOLCKER. If you were a depository institution eligible for discounting at the Federal Reserve, they would be discountable.

Mr. PAUL. So that the individual loses more than the institutions under these circumstances, because he does not have any way of discounting.

Chairman VOLCKER. They do not have any way of discounting directly with the Federal Reserve. They could do it with the financial institution. But when we lend money, it would not be simply on the security of the receivership certificate; it would be on the general credit of the borrower, meaning the depository institution, in this case, as well has the particular security.

Mr. PAUL. They would have to take the certificate and deposit it in an institution?

Chairman VOLCKER. They would have to make arrangements with their depository institution; yes.

Mr. PAUL. It is my understanding that in the process of their banking activities, Penn Square sold about 2 billion dollars' worth of loans. Do we know how many of the loans they sold are bad loans?

Chairman VOLCKER. I do not know that figure. The big banks involved—entailing the great mass of the involvement—have announced their estimates of their losses. Chase made an announcement yesterday; Seafirst made an announcement some days before; some of the other banks have announced as well.

Mr. PAUL. It has been perfectly legal during the process of the banking activity in the last several years for the banks that bought those loans to discount those loans—is that correct?

Chairman VOLCKER. With the Federal Reserve?

Mr. **Paul**. Yes.

Chairman **Volcker**. It is legal, but the normal way is not by discounting them in the technical sense of discounting. We do not buy the loans; we make an advance on the security of collateral.

Mr. **Paul**. And borrowing at the discount window?

Chairman **Volcker**. Borrowing at the discount window. If they were put in as collateral, we would make a judgment as to whether they were good collateral. To my knowledge, none of those loans has been used as collateral.

Mr. **Paul**. But they could have been.

Chairman **Volcker**. They could have been if they were good. Our discount officer would make a judgment as to the collateral, if it were used as a security. We try not to take bad collateral.

Mr. **Paul**. You said that in the last year, Penn Square did not borrow at the discount window, but prior to that, they did. Could you give me a figure on how much they borrowed?

Chairman **Volcker**. I can supply that figure. They borrowed intermittently for some period of time in the first half of 1981. The maximum, I think, was $8 million in 1 particular week, I guess; $100,000 in another week; and there are figures in between during that period. It was not continuous, but there was intermittent borrowing during that period.

Mr. **Paul**. Under the Monetary Control Act of 1980 we changed——

Chairman **Volcker**. I might say, just in case there were any doubts in anyone's mind in my earlier discussion with the chairman, we loaned them $20 million plus on a Wednesday which they paid off on Thursday and then we loaned something under $6 million on Friday, which was the last business day of the bank.

Mr. **Paul**. Under the Monetary Control Act of 1980 we changed the rules so that Federal Reserve notes could be stored in Federal Reserve banks without collateral. It was just to store Federal Reserve notes. Were any stored uncollateralized Federal Reserve notes needed either for Penn Square or for the Abilene Bank?

Chairman **Volcker**. I am not aware of any problem of that kind in the Abilene situation. We have plenty of notes in Oklahoma City, where we happen to have a branch, to take care of any needs that the Penn Square Bank would have had. I just do not know whether they were issued or unissued notes. They would have been issued had they been used.

Mr. **Paul**. I have a question regarding monetary policy. We talk target ranges of the different advocates, and I wonder how the Federal Reserve knows what the correct target is. Everyone assumes they know the correct target. There are some who claim that only the market determines the correct target.

It is generally assumed by most that the goal is to get the growth of money somewhat equal to the growth of the economy. We just went through a period of time wherein the gross national product, according to your report, dropping by 4 percent. Yet, in the same period of time, M_1 was going up at 5 or 6 percent.

So could the argument be made that possibly, you know, if the economy is decreasing we should have a decrease in the supply of money? It is baffling to try to understand how somebody arbitrarily picks out a figure and says that this figure is the "correct" target. It seems to me there is no relationship whatsoever between money growth. Why do we concentrate on this?

If money growth did stimulate economic growth, we would have had a tremendous decade in the 1970's, and we would have large real economic growth. We are having monetary growth. Especially if you look at M_3, the money growth is fantastic. I do not think you are all that tight on money growth. I think if you had a few shifts of a few percentage points out of M_3 and M_1 you would have an astronomical growth of "money," and yet, we don't have economic growth.

Chairman VOLCKER. I suppose the only general answer I can give to your question is that we are paid to make those judgments; we make them as best we can and we bring all the evidence to bear that we can on the issue.

Your example of the first quarter of this year is simply one example of the fact that these relationships are not close in a period as short as 3 months. There is a lot of room for fluctuation in the relationship between many of these M's and the gross national product in that length of time, or even over a period of 6 months.

We try to judge that and to make adjustments in targets or approach if necessary. The statistical link between the money supply, however we define it, and GNP is velocity. If you multiply the money supply by velocity, you get the GNP, because that is how it is calculated.

That is just another way of putting the problem, because velocity fluctuates very sharply in the short run. I believe this is a judgment that has to be made continually over a period of time, in the light of technical factors affecting the relationship—the use of computers, the ability to move money around faster, technology to economize on money, and other, more economic factors, such as what bears upon the incentives to hold money in relation to business activity, in relation to household expenses, and so on.

In a very general way, I touch upon these considerations in my statement. I noticed you asked why we do this. I think we do it because there is some feeling that there is a relationship between the supply of money and inflation. In very general terms, that is borne out by all of economic history.

There was considerable interest on this committee and in the Congress in specifying monetary targets more precisely and, indeed, over a longer period of time. I ran across a report that this committee wrote in 1979, just before I got here, that recommended we set out a very precise goal for money over the next 5 years.

I would resist that kind of thing because there are too many changes that may take place over that length of time. But that was a popular proposal, supported by this committee in 1979 and before that.

I do not think we have enough knowledge to make that kind of a judgment and adhere to it through thick and thin over that length of time.

The CHAIRMAN. Mr. Lundine.

Mr. LUNDINE. Mr. Chairman, you spoke in your statement of the economy being at a crossroads. I am concerned about the future of American industry. Our position seems to be precarious at this time. Unless we can revitalize our manufacturing base and become more productive, it seems to me, then any amount of financial manipulation will prove futile.

It seems that the combined effect of fiscal policy, which we are responsible for along with the administration, and monetary policy, which is largely your responsibility, has been to accelerate the deterioration of American industry. Even efficient businesses seem to be liquidating, while innovative, small businesses seem unable to expand or grow. Why should businessman take a risk when they get a high yield without any risk or very little risk?

How can we be so confident—as you conclude your statement on a very confident note—of completing the job, as you put it? Will that not—completing the job—destroy America's preeminent industrial position? How do you see this country's manufacturing business faring competitively in an increasingly competitive world in the next year or in the next 10 years?

Chairman **Volcker**. Let me describe the way I do see it. First, let me make one point that I think exists apart from these problems that we have now, just as a bit of background.

In the United States, in relative terms, manufacturing has been declining over a long period of time. It is a less important sector of the economy, and that is, in some basic sense, probably a reflection of our post-industrial society, economic growth, wealth and so on.

I just note that in the background. But I think the question you raised is a very important one. It is very important that we have a strong and competitive manufacturing industry.

When I look back at the previous decade, I ask myself: Were the trends then compatible with this need over a period of time to maintain a strong and competitive, efficient industry in the areas where it is important to maintain it? And I have some reservations; again, that was part of the whole inflationary process.

But, was industry paying enough attention to productivity and efficiency, or had they become somewhat distracted by financial manipulations, mergers, short-term profit schemes, and so forth, at the expense of investment and productivity over a period of time? Was labor sufficiently conscious of maintaining a solid competitive base for their jobs over a period of time? And I have some reservations on those scores.

If one looks at that kind of continuing consideration, it seems to me what is going on now is promising, in the sense that people have wanted to return to fundamentals and are concerned about basic problems of productivity, efficiency and competitiveness that are in the long run necessary to maintain a healthy manufacturing base.

You are obviously raising the other side of the coin as well. If that has been achieved in a context of serious recession, high interest rates, destroying the incentives to invest, you have a counterforce at work, and an indefinite prolongation of that counter-force at some point will undermine the very base that you are trying to achieve.

Mr. **Lundine**. Exactly. Excuse me. I do not mean to interrupt, but you appear to be kind of bullish on productivity.

Chairman **Volcker**. Right.

Mr. LUNDINE. But my question is, How are you ever going to get real productivity increases in steel operating at 40 percent of capacity?

Chairman VOLCKER. I am just coming to that. The concerns about recession, prolongation of recession, do work in the opposite direction, I think, at some point, and in the end you have to reconcile these views or dilemmas.

I do not believe this recession is going to last indefinitely. I think the prospects are favorable for some recovery; we will not cause that lasting damage to the industrial base that you fear and are rightly concerned about.

We have two things going on at the same time. Obviously the objective of policy ought to be to maximize all those favorable things that I can see coming out of this situation and minimizing the risks that you see.

Mr. LUNDINE. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Parris?

Mr. PARRIS. Thank you very much, Mr. Chairman. I welcome Mr. Volcker to this hearing. He is experienced, knowledgeable, qualified in the exercise of his responsibilities. And having made that uncharacteristically gracious remark, now for the bad news.

When two people agree on everything, Mr. Chairman, one of them is not thinking and I most assuredly do not agree with some of the positions of the Fed in regard to monetary policy and I am increasingly astonished at the certainty with which the Fed predicts the Nation's economic future.

I have the privilege of serving on the task force on economic policy. Over the last year or 2 I have had the opportunity to talk with a very large number of economists. Very few of them agree with our economic forecasts or yours. Very few of them agree on your continuing policies of tight money. And, in fact, very few of them can agree on whether or not it is even possible to measure the money supply, something that you claim to do, daily.

Edmund Burke said 200 years ago, "Parsimony is not economy." If that is good advice then, and I think it was, it is better advice today and I submit that it might be a little better if the Fed would factor a little bit more of that into its judgments.

I know that you take considerable pride in your dedication to tight money, but frankly I have—and I think I share that point of view with a number of my colleagues—a sinking feeling that the efforts that you are exerting to save the economy are equivalent to the PLO's efforts in West Beirut. When the battle is over, you may be able to claim a philosophical victory. The question is, at what price.

If the Nation's economy is reduced to a pile of rubble, the battle will have been won, but the war will have been lost. I think very frankly that is very close to where we are today.

Robert Ortner is one of the top economists in the country, as you know, and he is the Commerce Department's chief economist. He said last week if the Fed would speed up the money growth, interest rates would come down and the economy would begin to grow without reigniting inflation.

He said, "With production down the way it is, it would not be damaging or inappropriate if the Fed sped up money growth and consciously brought down interest rates." I would remind you that during the Ford administration your predecessor, Dr. Burns, increased the money supply dramatically to stimulate the economy and end that recession. The results were positive. The inflation rate stayed steady for months.

So it has been historically proven that there is at least a limited opportunity of high economic activity, increasing monetary supply, and stable inflation. My question is why don't we use it?

I submit, Mr. Chairman, that there is a legitimate question in, where is your crystal ball. Where is the Fed's statistics or information that permit you to be so certain, and presumably only you, that knows where the answer to the Nation's economic problems are? Where do you get the information that makes those decisions so infallible?

I think that rhetorical question is extremely important because if you are wrong, the possibility—I realize that understandably you would be reluctant to accept—you will have done a great and perhaps irreparable harm to the economy. I do not mean this in an ugly way, Mr. Chairman. These are judgmental, difficult, complex questions.

But I submit to you that instead of being remembered as the George Washington of modern monetaristic theory you may very well find yourself reviled by history as the Benedict Arnold of an economic disaster. I do not think you want that any more than I do.

The problem, frankly, is that if we do not do something to establish a long-term monetary policy we cannot solve the problem and I submit that we have nothing in today's situation that inspires confidence. Nobody trusts the money. The economy, worldwide, is in a precariously dependent short-term debt situation.

Now, to go on with my question, Mr. Chairman, having been given the proverbial pink slip——

The CHAIRMAN. The time of the gentleman has expired. He may put the question in writing.

Mr. PARRIS. He will get the opportunity perhaps later in this hearing to respond to the question of how do we break this logjam and I thank the Chairman for his indulgence.

Chairman VOLCKER. Can I take 30 seconds, Mr. Chairman? Obviously given the series of questions or comments you made we could go on for hours. In a sense, you have answered the question. It may come down, in the end, to a matter of judgment.

We try to make the best judgments we can in a difficult situation, with many conflicting considerations. I repeat, I think we have made progress in some respects. We have a very serious recessionary problem. We will continue to make the best judgments we can and, without any pride, I can assure you, speaking for myself, we make these judgments without much worrying about how our policy is going to be characterized in the history books.

The job is difficult enough in the here and now to make those judgments.

The CHAIRMAN. Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Volcker, I appreciate you coming up and presenting this to us. I am a little dismayed at the lack of insight into the current problems that we face and the projections that you make for next year. I think it really begs the question of whether we had the need for a Federal Open Market Committee and that you have surrendered and they seem to have surrendered their judgment to a number of indices, imperfect as they may be in determining monetary policy.

Indeed, some have said we are driving a car with one foot on the brake and the other on the accelerator. I think the driver also has a blindfold on at this point. I really do not believe the monetary policy indices that you use are that accurate. I note that your methodology change in terms of seasonal adjustment factors, as you point out.

But here we have an economy that is at a 40-year low. In all candor, I think we are looking at the bones of not just the discredited fiscal policy but looking at the bones and the ashes of a discredited monetary policy. I am willing to admit—and I think all of us would take it seriously—that Laffer economics did not work. Cutting taxes and pursuing the type of role—and apparently one you supported last year, if my memory serves me correctly—did not do the job that it was supposed to do in terms of business investment, in terms of stimulating the consumer.

Now we may disagree on the genesis of that, but nevertheless that is where we are. So we have negative statistics, bigger deficits, higher unemployment, more bankruptcy, more business failure. What do you forecast and what are you going to do about it? That is what people ask me.

They say what are we going to do about higher interest rates or monetary policy. But you insist on driving the monetary policy, as I said, in a blindfolded manner. You have a responsibility under Humphrey-Hawkins, but I submit this report does not comply with the intent of what that law was in terms of how you are directing.

I think it is a casual treatment of problems that are very serious in this Nation and are probably going to result in an overreaction.

Indeed, the only voice of dissent might be from those of us in Congress, such as myself and Henry Reuss and others, regarding monetary policy. So I see no difference. I see no response to the present circumstance, no leadership coming forth.

Such questions are: Are we changing the characteristics of our financial institutions by the type of monetary policy and velocity we have today? I submit the answer may very well be yes.

Are we changing the pattern of our economy in terms of consumer goods? People cannot afford housing. Despite your statement with all its optimism, maybe your response would be different had you seen the statistics yesterday before you gave it. Many people cannot even afford housing any more. We are going to be under 1 million units this year.

Are we shifting, for instance, the consumer pattern to other things like tape recorders and other things that may not be as important to the economy as automobiles.

Congressman Leach raised the question of mergers and the $200 billion or whatever amount of credit that is going for mergers. Clearly that has an adverse impact on that question of productivity in small businesses and so forth. No effort to qualitatively judge how the limited amount of credit is being used has been made.

Policy shifts that are directing money away from housing, away from some of the traditional industries that need them, tax policies going backward and in your statement, you say that things are going to get better?

I do not think they are going to get better, Mr. Chairman, unless we do something about it. I do not see any initiative here in terms of the Federal Reserve Board suggesting that they are going to do anything about it except continuing to drive this monetary car, this monetary vehicle, blindly.

Chairman **Volcker**. I must make a couple of comments in response. There is one thing we are not in approaching our responsibilities—casual. I want to reject that allegation entirely.

You refer, for instance, to homebuilding. I think what I said about homebuilding in my statement is precisely that homebuilding has remained at depressed levels despite some small gains in starts in spring. The cyclical strength normal in that industry is lacking. That is hardly a great encomium to the conditions in the housing industry at this point in time.

Perhaps some of our difference can be traced to the difference in time perspective. There is nothing in my statement and nothing in my feeling to indicate that we face anything but a difficult problem. I think there are indeed encouraging developments going on in the economy that promise to produce a much better economic performance in the 1980's and beyond than what we had in the 1970's.

I guess I will have to rest on that proposition.

Mr. **Vento**. Mr. Chairman, I would hope the Chairman would answer my questions more fully. I will submit them in a written fashion.

Chairman **Volcker**. I would be willing to answer any——

Mr. **Vento**. My time has expired, Mr. Chairman, but I am not in any way trying to suggest that you are trying to avoid answering my questions, except I did not give you the opportunity to do so, and if there is any fault, it is on my part.

The **Chairman**. Mr. Weber?

Mr. **Weber**. Thank you, Mr. Chairman.

Chairman Volcker, the Commerce Department this morning released the figures for the second quarter of GNP growth. Real growth in GNP during the second quarter of 1982 was up 1.7 percent on a preliminary basis from the first quarter. I understand this to be higher than the Department of Commerce has expected by about 1 percent and does contrast with the 5.1-percent real decline in the first quarter of GNP this year.

What would be your comments about those statistics?

Chairman **Volcker**. Excuse me? I was distracted for a moment.

Mr. **Weber**. I understand that the real growth in GNP——

Chairman **Volcker**. Yes; I heard that part.

Mr. **Weber**. What would be your comment about those figures that have been released? Are they encouraging to you?

Chairman **Volcker**. I would not make a big thing about the difference between the figures, it is about a 1 percent difference, as I understand it, between the earlier and the present figures. I think it is consistent with what I have said earlier and consistent with my best judgment that the decline stopped during the second quarter.

You had a potential bottoming-out process at work. I have not analyzed the figures in detail. I know the total and that is about all I do know. But I think it is consistent with the view that we are seeing some process at work, rather laboriously, of what could be the beginnings of a recovery.

I would say the June figures were not particularly good. They were bad, and that is another element in the situation. But in general terms, the second quarter figures seem to reflect a development broadly in line with our expectations.

Mr. **WEBER**. Thank you. I would like to give you the opportunity to comment more fully on Congressman Parris' observation that apparently during the Ford recession, if we wish to call it that, the Chairman or the Fed, under the leadership of Chairman Burns, at that time did expand the money supply more rapidly than the Fed has done during this recession.

Chairman **VOLCKER**. I went back and quickly checked my memory on that. I think it is accurate to say that in the first year or so of that recovery the increase in the money supply was rather modest.

The money supply speeded up in 1977-78, in my recollection, but in the early period of that recovery we had a very rapid increase in velocity and a rather modest increase in the money supply.

Mr. **WEBER**. Any observations as to whether that should have been tried this time?

Chairman **VOLCKER**. Without getting down to the decimal points, the idea that velocity can expand rapidly in recoveries, particularly in the early stages of recoveries, was certainly exemplified by that experience.

Of course, you never know the future with the certainty you know the past, however arbitrary the numbers are. But I think that is historically based, and the normal presumption of what would happen during a period of recovery.

The kind of monetary targets we have—at least the M_1 target—assumes growth in velocity. That is why we think it is fully consistent with and accommodative to economic recovery during this period. The lower the inflation rate—we have been doing a little better than we expected—the more room you have for real growth.

Mr. **WEBER**. It is a rather general question, but can you offer any hope near-term to the interest-sensitive sectors of the economy, such as farming and housing and the thrift industry?

Chairman **VOLCKER**. We can at least say the most recent movement has been downward. Beyond that, it does seem to me, given the kind of evolution I see in the economy and what I see with respect to inflation—and talking not only that in terms of its immediate impacts but in terms of what I would think is a healthy influence on expectations as time passes—that these interest rates, even given the recent declines, still seem extraordinarily high in terms of the environment that I would see in the future.

I think you can draw your own implications from that. I hate to keep repeating it, but a major hazard in the interest rate outlook over the longer period of time remains the fiscal position.

The **CHAIRMAN**. Mr. Patman?

Mr. PATMAN. Chairman Volcker, when the Federal Reserve sets its monetary targets and makes changes in monetary policy, does it estimate the results of such targets and policies on: one, small business bankruptcy rates; two, rates of employment; and three, projected levels of interest rates?

Chairman VOLCKER. We certainly look at the broader economic indicators, like unemployment and interest rates and inflation and employment and that kind of thing.

Mr. PATMAN. Bankruptcy rates, too?

Chairman VOLCKER. I cannot say we make a specific projection of bankruptcy rates, but you would expect that to be a reflection of what goes on in the economy generally.

Mr. PATMAN. But you make projections, not only observations but projections, of what your new policies will do with those indices, right?

Chairman VOLCKER. The staff does; yes.

Mr. PATMAN. My farmers, ranchers, and small businessmen could use that information. Could you make it available?

Chairman VOLCKER. We put in the Humphrey-Hawkins reports the judgments of the various members of the committee on those.

Mr. PATMAN. That's true, but I believe you made five changes last year and I don't believe you released it each time you made those changes, did you?

Chairman VOLCKER. You refer to five changes?

Mr. PATMAN. Five changes in your monetary policy.

Chairman VOLCKER. We have not made any changes in the stated targets. We have certainly modified our interpretation of them, as my report to you today indicates. The decisions we make from month to month are important operating decisions, but I would not call them changes in policy.

Mr. PATMAN. Right. But you do make changes which affect those indices, and you make projections at the time you make the changes, right?

Chairman VOLCKER. We make them, particularly at semiannual intervals; yes.

Mr. PATMAN. I'm not talking about the semiannual intervals. Is this Humphrey-Hawkins report the result of some change that you have made or some examination of your policies with respect to these indices, the changes you've made?

Chairman VOLCKER. Of course, we have a complete reexamination at this time. In our other meetings we look at these things, too.

Mr. PATMAN. But I think you have stated this does not represent a change. You are not changing your monetary policy; is that true?

Chairman VOLCKER. I leave you to judge that, I suppose. I have tried to explain as carefully as I can precisely what our intentions are. If you want to characterize it as stability or something else, I leave that to you.

Mr. PATMAN. I am trying to draft a bill that would permit you, and maybe require you, to release these projections of indices that you necessarily make when you make a change in monetary policy. These are changes in projections that I think would be very useful to the American public and in particular to those in small business and in farming and ranching.

Could you support such a bill?

Chairman VOLCKER. I do not know just what the bill would call for.

Mr. PATMAN. I want you to do more in the way of releasing the information.

Chairman VOLCKER. I would resist the idea that every time the staff prepares a forecast we should publish it. I think that would be very inhibiting in terms of the process of drawing up the estimates and the forecasts in the first place. If they were all going to be part of the public record, I think that would undermine the policy formation process and not contribute to it.

Mr. PATMAN. The automobile industry is still dying. The housing industry is in the hospital. Small businesses are failing in record numbers, and the farmers are selling off their breeding stock and equipment.

When, in your judgment, will we have a crisis on our hands? Credit is the lifeblood of our farmers, ranchers, and small businessmen. I told you before and I will tell you again that there will not be any demand for blood after all the patients have died.

Chairman VOLCKER. I have given you the best judgment I can give, and it is reflected in the forecasts that you see in the document that you have. The best judgment suggests the likelihood of recovery in the second half of the year, and I hope that that recovery will turn out to be a harbinger of a very long period of sustained recovery.

Mr. PATMAN. Well, this harbinger, whatever you want to call it, these harbingers that you see also indicate to you that we will have an unemployment rate in 1983 of between 8½ to 9½ percent. Is that what you call a recovery?

Chairman VOLCKER. I think that is consistent with a moderate recovery, unfortunately. If you ask me whether that unemployment rate is far too high for the economy over a period of time, it is; if you ask whether that is a satisfactory unemployment rate, it clearly is not.

Mr. PATMAN. What is your projection on the bankruptcy rate for next year?

Chairman VOLCKER. I do not have a specific projection on the bankruptcy rate for next year.

Mr. PATMAN. Can you get us one?

Chairman VOLCKER. I do not think I can get you a meaningful one. It is not an indicator we normally project.

Mr. PATMAN. Would you give us the best estimate that you can make?

Chairman VOLCKER. I can have the staff take a stab at it and I would be happy to do that. I am not going to promise you a result.

Mr. PATMAN. Thank you, sir. And of course, the basis for that, please.

The CHAIRMAN. Mr. Wortley?

Mr. WORTLEY. Mr. Volker, I have a question on contemporaneous reserves reporting. When do you expect to do that and how do you expect to accomplish it, and what effect do you think that will have upon your monetary aggregates?

Chairman VOLCKER. The Board has not decided precisely what deadline to put on it. My estimate would be that we are speaking of a framework of a year or so, because it takes a considerable period of time both for us within the Federal Reserve to adjust the computers and the computer programming, and certainly for some of the banks to do the same thing.

I personally would expect the results to be modest.

Mr. **Wortley**. Are you contemplating any other further changes? You talked a little while ago about coming out with the M_1 figures on a monthly basis instead of weekly.

Chairman **Volcker**. We certainly contemplate that. We have run into what can only be called a technical snag in seasonally adjusting them. But we will do that very shortly.

Mr. **Wortley**. What other indices or figures might you change in the near future?

Chairman **Volcker**. I do not have any specific changes in mind, personally. There has been a good deal of interest and concern in this committee about looking at credit aggregates. That is something we do look at in a less formal and, the word that comes to mind is, simplified way as compared to the monetary aggregates. It is looking at the other side of the balance sheet. If people think that is useful, then it may be useful to give a little more prominence to that kind of indicator.

Mr. **Wortley**. Speaking of credit, how do you account for the fact that borrowing, short-term borrowing, has been as strong as it has been during this recession?

Chairman **Volcker**. I do not know that I can cast any additional light on it or give any further explanations than what is often heard. First of all, considering the size of the economy, there has been a lot of relatively short-term financing for perhaps obvious reasons—the idea of not wanting to commit to high interest rates for a long period of time on the part of the borrower. What borrowing there has been has been pushed back into the short-term sector for that reason.

It appears to me that businesses are probably beginning to build liquidity to some extent. You probably have a great mixture of firms; some are very hard-pressed and have to borrow as a matter of necessity to maintain cash balances to do business, while others are probably building up liquidity. There is a certain amount of what might be thought of as precautionary borrowing, borrowing to rebuild liquidity.

A mixture of those motivations has contributed to a concentration of a lot of short-term borrowing from the banks or in the paper market. The total borrowing by businesses is not as large as it looks if you just look at that short-term borrowing, but all the borrowing that has taken place, to overstate it a bit, is very much concentrated on that narrow sector of the market.

The cash flow position of businesses has, of course, been affected unfavorably by the profit decline. On the other hand, it has been favorably affected by depreciation allowances. And with the amount of inventory liquidation going on, the net cash flow position of businesses actually looks exceptionally good. In other words, if you subtract investment from the gross cash flow you do not have an indication of much external borrowing. That is looking at the universe as a whole.

The borrowing need is certainly larger than you would expect it to be just looking at the cash flow situation. I think that has to be explained on grounds of both differences among firms and a desire to build up liquidity.

Mr. WORTLEY. Some people were a little disappointed the other day when you only cut the discount rate by a half of a percentage point. Do you contemplate any further cuts?

Chairman VOLCKER. That, of course, will depend upon the evolution of market rates, the money supply, the economy, and all the rest. I would not want to rule it out.

Mr. WORTLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Chairman Volcker, I want you to take note of the fact that you obviously have either the greatest fans and admirers in history or someone who really has some piercing questions for you, because the next member to be called upon is at the end of the totem pole, you see, and he has been sitting here patiently, persistently, and with utmost tenacity. I give you Mr. Hoyer.

Mr. HOYER. I am going to have dinner with the chairman tonight and I did not want him to chastize me for not attending and listening to his words.

I apologize for missing your statement. I was at the Post Office and Civil Service Committee working to protect my Federal employees.

Mr. Chairman, you mention on page 13 of your statement something to which you have referred consistently. This is of course that you have responsibility for one-half of the ballgame and the Congress and the President have perhaps an even more significant responsibility on the other side, that is, on the fiscal policy side.

A number of us are working on some proposals with respect to the budget, and I am going to take this opportunity to determine what you, in fact, do with respect to the estimating of revenues. Clearly, it is difficult for you to estimate what expenditures are going to be, but that must enter into your judgment as it relates to this question of crowding out in the market.

What do you do, Mr. Chairman, in terms of estimating what Federal revenues will be in your shop by the latter part of this year?

Chairman VOLCKER. If you were looking at a near-term estimate of that sort, you would simply take an economic forecast and attempt to divine how much revenue that is likely to generate, given the tax structure that exists. You have quite a different problem as the time horizon lengthens.

Mr. HOYER. Let me ask you something. Do you do that in-house?

Chairman VOLCKER. Yes.

Mr. HOYER. In the State of Maryland we have what are called Revenue Estimate Boards. They make estimates. They give the estimates to the Governor. Although the Governor plays a role in developing them, he is not necessarily the controlling factor. Both the executive department of government and the legislative department of government are bound by those revenue estimates.

I have only been here a short length of time, but in both periods of time either Mr. Stockman or ourselves have in effect factored the computers that would come out with results better to our liking.

If we had an independent board of revenue estimates, if you will, as many States and localities have, it seems to me that would bring some discipline to the process. My own view is that it would perhaps be appropriate to have you sit as a member of that board, because of the fact that in-house you are now processing such projections.

Do you have any thoughts on that? And I will follow this up tonight.

Chairman VOLCKER. Obviously, I am giving you a very immediate reaction to a question which I really have not considered. My immediate reaction is that I would be very reluctant to see the Federal Reserve thrust into that particular process.

I do not know that as we have any expertise in this area that a lot of other people do not have. It becomes, as your question implies, a political process, and I would question whether we should attempt to inject ourselves into that process.

In a way, the more difficult part of your question was asked. In my view, you are asking, in the context of the next 6 months, the natural thing to do is simply estimate revenues on the basis of what your best judgment is on what the economy is going to do.

But when you are planning, for fiscal policy purposes, over a year ahead, over 2 years ahead or even longer, as the Congress now does, I think you are not interested simply in somebody's forecast of the economy, which may be wrong; you are interested in what the revenue-generating capability is of the tax system, given normal economic activity or given satisfactory economic activity, which is a different question.

I raise the point because I think you cannot measure the appropriate budgetary posture simply from where the budget deficit stands today or next year or the following year if you are in a recession, let us say.

Mr. HOYER. Mr. Chairman, I understand that. What I am looking for is an independent source to say, under given standards now and forgetting about the Congress ability to change the policy and to generate more revenues or less revenues depending upon what it needs to be the best policy—I am looking for some discipline to start the processes. Under existing circumstances, what are appropriate, in effect, nonpolitical revenue estimates?

Chairman VOLCKER. Your object is to get some independence into this process.

Mr. HOYER. Correct.

Chairman VOLCKER. I respond to you that offhand, listening to this for the first time, that while I greatly appreciate the independence of the Federal Reserve I am not sure we should be called upon to answer every question that arises in this context.

Mr. HOYER. I will pursue it tonight, if I may. My time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. If we could revisit the use of the discount window in Penn Square, I would like to ask you a few more questions. You decided to allow, $20 million 1 day and on the following day $6 million.

Chairman VOLCKER. In round numbers.

The CHAIRMAN. So when the bank closed they owed you $6 million, is that correct?

Chairman VOLCKER. That is correct.

The CHAIRMAN. Was that decision to lend those funds and allow the use of the discount window made in the regional Kansas City office, or was there any contact with the Fed in Washington?

Chairman VOLCKER. In this particular case they were in contact with the Fed in Washington.

The CHAIRMAN. Was that because the Fed in Washington was aware of the status of Penn Square and the problem loans?

Chairman VOLCKER. We had become aware recently, yes.

The CHAIRMAN. Do you know, was it the Comptroller's Office that informed you of the situation or was it the FDIC?

Chairman VOLCKER. To the best of my knowledge we first learned about this through an inquiry, more or less a routine inquiry that one of our people had made to the Comptroller's Office.

The CHAIRMAN. That one of your people had made of the Comptroller's Office?

Chairman VOLCKER. Yes.

The CHAIRMAN. What gave rise to this individual's making the inquiry of the Comptroller's office?

Chairman VOLCKER. The individual was specifically interested in knowing if there were any problems in the banking industry that he did not know about already.

The CHAIRMAN. OK. Was that a general question, to wit, Mr. Comptroller, what is the status of the problem banks? Or was it specifically directed to Penn Square?

Chairman VOLCKER. No, it was not directed to Penn Square.

The CHAIRMAN. Would it be possible to find out who this persistent individual is?

Chairman VOLCKER. Yes, but I do not know what purpose would be served.

The CHAIRMAN. It might be helpful to us in factfinding as time goes by.

Chairman VOLCKER. I would prefer to discuss that later.

The CHAIRMAN. All right, we can discuss that a little later.

Chairman VOLCKER. That is how we first found out about it; I am not saying that we would not have found out about it in another way subsequently.

The CHAIRMAN. Do you know approximately when this information came to the attention of our persistent individual?

Chairman VOLCKER. Oh, a week or so before.

The CHAIRMAN. About a week prior?

Chairman VOLCKER. Yes.

The CHAIRMAN. If I were you, I would feel hurt about that, because Continental and the bankers had been informed about that same time without the inquiry. They were given the information. You need not comment.

You say those advances, the loans at the discount window, were secured. No. 1, you said that you had preferred status.

Chairman VOLCKER. We have a secured loan.

The CHAIRMAN. But no preferred status?

Chairman VOLCKER. Only in the sense that it's a secured loan.

The CHAIRMAN. Secured by what?

Chairman VOLCKER. It was part of their loan portfolio.

The CHAIRMAN. Loan portfolio?

Chairman VOLCKER. There may have been something else in there, but essentially their loan portfolio.

The CHAIRMAN. OK. Now, in view of the fact that many of those loans were not worth very much, they vary in value, let us say at the close there was a $6 million advance of loans from the discount window. The loan that you have as collateral is in what amount?

Chairman VOLCKER. Considerably in excess of that. I do not know what the number is.

The CHAIRMAN. Would it be possible to ask that we have what the ratio is? Is that information available?

Chairman VOLCKER. I am sure it was very high on that day, because we made a $20 million loan 2 days before.

The CHAIRMAN. What I would like is, what was the collateral on the day of ther first loan, as well as on Friday?

Chairman VOLCKER. I cannot tell you that offhand.

The CHAIRMAN. I realize you do not have it here at the moment, but I think it would be beneficial for us to know that.

[At the request of Chairman St Germain, the following additional information was submitted for inclusion in the record by Chairman Volcker:]

RESPONSE RECEIVED FROM CHAIRMAN VOLCKER

The first loan was made on June 30. It was a one-day note for $20 million. It was collateralized by about $27 million (face value) of customer notes; none of the customer notes were "criticized."

The second loan was made on Friday, July 2, and was to run through the weekend. It was for $5.7 million due July 6. Collateral of about $7.5 million was needed for this loan; much more was in fact on hand, including the amount available on June 30 plus an additional $15 million. Again, these were not "critized" loans. The second loan was paid off on July 6 by the FDIC.

The CHAIRMAN. Mr. Evans, you passed on your first round. Would you like to be recognized?

Mr. EVANS. I would like to ask a couple of questions, Mr. Chairman.

Mr. Volcker, I appreciate the opportunity to be able to ask you a few questions. I see you on television, but rarely do I see you in person. It is very clear that these are times of stress from an economic standpoint, and in times of stress, one looks for a whipping boy.

I must say that I have avoided using you as that individual as an excuse for the problems we have in terms of unemployment and high interest rates, but I must also say I would like to see you a little less rigid in your approach to the increase in the supply of money in view of the situation we are in.

If you have a patient who has been in a pretty bad automobile accident and you have to get him to the hospital, even though you might find a marvelous intensive care unit at the hospital, you have to first get him there, and sometimes you need a little plasma to get the patient to the hospital. Some moderate increase now in the money supply might be the plasma needed for our economy.

I realize fully that monetary policy is not the only answer to solving the problems of inflation and unemployment and high interest rates, and I realize also fully that perhaps monetary policy over the past several years has contributed to the lowering of the inflation rate, which is, in effect, the most insidious tax of all.

You have reduced that inflation rate from 1980 down to about half of what it was during that year, and I applaud your efforts from that standpoint. But I hope that you recognize that that is not the only factor that we have to look at.

I was pleased to see that on page 17 of your report of the Board of Governors of the Federal Reserve System, your midyear monetary report to Congress, you say that because inflation cannot persist without excessive monetary expansion, appropriately restrained growth of money and credit over the longer run is critical to achieving lasting priority. That leaves a degree of flexibility through the short term. I was pleased to see that.

I had indicated before that the inflation rate has slowed dramatically in the last one and a half years. How much of this do you believe can be attributed to the changes in 1979 in the Federal Reserve operating procedures? Because as you know, previously you controlled interest rates, and that has been changed to the control of the monetary aggregates.

How much do you say that has played a role in reducing inflation?

Chairman VOLCKER. I do not think you can answer that question in those terms. The shift from what you call interest rate control to reserve control is a technique to achieve a purpose. In concept, the purpose could have been achieved with another technique. The question is, Would it have been?

When people say we used to control interest rates, we did so in a very limited sense from week to week or month to month. We looked at Federal funds rates more intently, and stabilized the rate in the short run. That did not imply long-run stability of that rate because that was a mechanism to control the money supply.

We now have a different mechanism of controlling the money supply, but, in a sense, I do not consider that, in itself, a fundamental change in policy. The policy would be reflected in the degree of "intentness" with which we pursued the targets with in the first place.

Mr. EVANS. Mr. Chairman, I realize you have to do a very fine balancing act because you do not want to fuel the fires of inflation by a too rapid increase in the money supply, but I was very pleased to read your report because I think you do leave open the approach of being more flexible over the short term.

Do I read you correctly on that?

Chairman VOLCKER. I suppose that what I say may be interpreted differently from what I think I said, but you are using words like "rigidity" or applying "lack of sensitivity," and I do not read my report as implying that.

I think we mean to convey a concern about judging money supply developments in light of what is going on, in a technical sense, with respect to the demand for money, and that is a much broader setting. Also, we need elements of flexibility in these targets.

Mr. EVANS. I am pleased that you understand that. You are predicting an upturn in the economy activity in the second half of 1982. The Commerce Department just indicated the second quarter of this year we had a 1.7-percent growth in our GNP. That is good news. I would like to see that sustained.

But can you point to any specific factors that indicate that that growth might be sustained? And do you think it could be sustained into calendar year 1983?

Chairman **Volcker**. There are two or three factors that I just touched upon briefly in my testimony. Recovery in the second half of the year, in my judgment, will be led largely by sustained and increasing consumer expenditures. We had some of that in the second quarter. We had a dip in June, according to the preliminary figures, but, of course, on July 1, we got an additional impetus from the tax cut.

More generally, I think the size of the Government deficit itself, whatever else you can say about it, does tend to sustain purchasing power. I think you have to look to the consumer to be the important sustaining factor.

You have to put that in conjunction with the fact that we have had a considerable inventory liquidation in the past 6 months. Inventory movements are notoriously difficult to project in the short run, but with due allowance for the uncertainties inevitable there, we have had enough liquidation so that if consumption is sustained and increases, you would think that, at the very least, that rate of inventory liquidation would go down.

When the rate of inventory liquidation subsides, that means production will go up, because you cannot live off the shelf; you have to start production again with production going up.

Mr. **Evans**. What is the potential for that?

Chairman **Volcker**. Of course, income is generated which feeds back and helps consumption. You have one area in Government spending where both orders and spending are going up, and that is the defense area; that is another factor that could be cited.

I would not expect business investment to come along until next year.

Mr. **Evans**. Thank you, sir.

The **Chairman**. Mr. Hubbard?

Mr. **Hubbard**. Mr. Chairman, I have no questions, but I would like to express my appreciation to Chairman Volcker for his testimony and his answering our questions today.

Mr. **Parris**. Mr. Chairman, could I just make one very brief observation? I promise it will be brief.

To return to my short question of earlier, Mr. Chairman, Samuel Briden said the problem with monetarism is that it concedes too much power to official intervention, underrates the influence of competition, providing money substitutes, and takes official statistics far too far at their face value.

Now, assuming for the sake of argument, Mr. Chairman—and I would love to have an hour to debate monetary policy, economic theories, and we certainly do not have that much time—basically, the goal of managed money is to control three trillion dollars in the greatest economic system the world has ever known, in annual spending through a periodic adjustment by the Federal Reserve Board of about $45 billion of bank reserves.

Now, that is not an easy task, Mr. Chairman. I question whether or not you really think, in the real world, that it is possible to do that successfully.

Chairman **Volcker**. I agree with the thrust of your comments earlier and just now, that any of these measures of money is a very imperfect tool—I have emphasized that point repeatedly myself—particularly when technology is changing so rapidly.

The definition of money, in the last analysis, at the margin is arbitrary.

Mr. **Parris**. You have changed the definition four times.

Chairman **Volcker**. We have changed the definition to try to keep up with it, and that is why we look at more than one indicator. I think it would be exceedingly dangerous to lock into place one particular indicator of money and stick with that through thick and thin forever. We do not live in that simple a world.

You point out we have got the leverage on that through $45 billion of reserves; there is a lot of slippage between that reserve number and the money supply number, and there is slippage between the money supply number and the economy. If you say this is the only tool we have for everything that happens in the economy, obviously, viewed in that light, it is clearly and patently inadequate.

There are a lot of other policy instruments, even within the monetary policy framework; that alone is not the answer to all questions. And there are many things going on in this economy that are outside the control of that particular tool.

Mr. **Parris**. Thank you, Mr. Chairman. Just one additional sentence. The seductive premise that m plus or minus v or times v equal gross national product—if we could count and control m and if we could predict v, then we would reach the heaven, the Keynesian heaven of being able to manage aggregate demand. And the problem with that is that nobody can do any of those things in the real world.

Chairman **Volcker**. Certainly not in the short run. I am afraid that would even be some distance from heaven because we would want to know how much the nominal GNP is prices and how much is real; and certainly nothing within that simple relationship is going to tell you that in a straightforward, consistent way, in the short run, at least.

Mr. **Parris**. I thank you, Mr. Volcker, and thank you, Mr. Chairman, for your patience. I appreciate it.

The **Chairman**. I think Mr. Patman wants to get a little closer to Heaven, too. [Laughter.]

Mr. **Patman**. This has not been Heaven today, I will tell you that. [Laughter.]

The more that we are hearing about the economy, it is far from it, way down.

Mr. Chairman Volcker, is it true that high interest rates have helped cause the recession?

Chairman **Volcker**. In an immediate sense, but again you have got to come back to the question of why we have the high interest rates in the first place. What are the dislocations in the economy that caused this total situation?

Mr. **Patman**. Right. Have the high interest rates caused the high budget deficits that we have, or contributed to those?

Chairman **Volcker**. They have—again, I would give you the same answer.

Mr. PATMAN. And there will not be any argument about this, I guess, have the high interest rates helped to contribute toward the high bankruptcy rates we have in this country at this point?

Chairman VOLCKER. I would give you the same answer.

Mr. PATMAN. Let us have that answer a little bit more fully then.

Chairman VOLCKER. You are picking out one factor in a very complex situation, and it is certainly a factor——

Mr. PATMAN. A very——

Chairman VOLCKER [continuing]. But it immediately raises the question as to why interest rates are so high, and what can you do about it without having other adverse effects.

Mr. PATMAN. Right. Irrespective of why they are high and what you can do that might cause worse effects, the high interest rates have caused a lot of bankruptcies in this country, do you not think?

Chairman VOLCKER. I am sure it has caused some, but that is an inadequate answer because you have to ask what caused the high interest rates.

Mr. PATMAN. Well, let us get to that. Have the tight money policies of the Fed contributed to the high interest rates?

Chairman VOLCKER. Let me put it this way. For many years, for literally decades, businesses have let their liquidity positions run down. The ones that are most threatened with bankruptcy or went bankrupt are the ones that did not have adequate cash when they started or were very dependent upon short-term borrowing as a great generalization. I could ask: what caused the bankruptcy?

What caused the bankruptcy is that they let themselves get into a position where they did not have liquidity. Why did they let themselves get into that position? Because for a decade they had assumed that inflation was going to bail them out, and they could borrow, and they did not have to maintain any liquidity position. That is an equally accurate answer, I think, to your question.

Mr. PATMAN. Well, your tightening up of the money supply certainly tightens up liquidity, does it not?

Chairman VOLCKER. Yes.

Mr. PATMAN. All right, now, have you tightened it up too much in recent years in any instances that you know of, say in the last 2 years——

Chairman VOLCKER. You can always debate—— .

Mr. PATMAN [continuing]. In such a way that you have contributed to higher interest rates than we needed to effectuate a sound monetary policy?

Chairman VOLCKER. I am sure that economists can debate that for years. Some think not enough; some think too much.

Mr. PATMAN. Well, in your judgment?

Chairman VOLCKER. In my judgment, I was here during the last couple of years, so I guess I am bound to think it was reasonable under all the circumstances. [Laughter.]

Mr. PATMAN. Is that your sworn testimony?

Chairman VOLCKER. That is my sworn testimony. [Laughter.]

Mr. PATMAN. The rates of Treasury bills have recently declined because of the flow of funds toward the purchase of short-term Treasury bills to some extent, because of the insecurity investors feel in the market nowadays, and especially insecurity in other investments such as short-term paper of corporations, I understand. That seems to indicate a lack of confidence in the economy, does it not?

Chairman **Volcker**. Yes. That is not the reason that Treasury bill rates, in my opinion, have declined fundamentally. That may have made them decline more than other rates declined, but all short-term rates have been declining during this period.

Mr. **Patman**. In announcing the reduction of the discount rate to 11.5 percent on Monday, the Federal Reserve Board said:

> The action was taken in the context of recent declines in short-term market rates and the relatively restrained growth of money and credit in recent months.

Now I understand that most market participants view the discount rate under current operating procedures as a prop under the Federal funds rate. Do you agree with that?

Chairman **Volcker**. In some conditions it will—I will use the word I used yesterday—kind of "anchor" the Federal funds rate—not very precisely, but it influences it.

Mr. **Patman**. Well, if that is true, then can you say that the change in the discount rate reflects the change in the market conditions? Or that it causes the change in the market conditions?

Chairman **Volcker**. There is always a little bit of both, but I think in this instance we felt able and felt it desirable to reduce the discount rate because market rates had come into touch with the discount rate, and we had a rather moderate growth in the money supply recently.

Mr. **Patman**. Other things being equal, you can manipulate the short-term rate by reducing the discount rate; isn't that true?

Chairman **Volcker**. You say "manipulate."

Mr. **Patman**. It would reduce the short-term rates.

Chairman **Volcker**. It would depend very much upon the environment in which you did it. You could have some influence, certainly, in the short run. But the nature of that influence, the pervasiveness of it, the lasting quality of it, is going to depend on many other things.

The discount rate—you can note instances in the fairly recent past—has been quite different from market rates. The discount rate did not change between December and just now, and you had quite different short-term and long-term market rates during that period when the discount rate didn't change at all.

Mr. **Patman**. In the context of the tight money policy and the tight money situation, when large corporations borrow large amounts of money in order to purchase other corporations—the merger procedure, in other words—does that exacerbate the tight money situation for others?

Chairman **Volcker**. Economic analysis would suggest that it is not an important influence in the sense that the money is borrowed to buy a corporation, let's say, and by definition, you pay it to the owners of that corporation.

If you assume that the owners of the corporation put the money back in the market, in the broadest sense, you have a wash. You have increased the demand for the loan to buy out the stockholder, who turns around and, in effect, finances the loan, but indirectly.

Mr. PATMAN. All right. But if you get five corporations each getting lines of credit and tying up $5 billion worth of credit, instead of one corporation borrowing $5 billion in order to purchase another one, aren't you tying up $25 billion instead of $5 billion?

Chairman VOLCKER. Yes, I would think you could argue that simply having these commitments on the books has to make the bank more cautious about other lending. If you ask a banker that, he usually tells you that is not the case. I ask the banker, isn't he controlling his commitments? So I think there is something to your point.

Mr. PATMAN. When you get some recommendations for us on how we can make sure that these things such as tying up large amounts of credit and causing detrimental effects on the economy, from that practice—when you get some recommendations on how those can be handled in a better way for us or by you, I wish you would let us know.

Chairman VOLCKER. I would be perfectly happy to do that.

Let me just say that I think the principal problem you run into in this area is who makes the judgment as to whether it is a good merger or a bad merger, and all that kind of judgment.

Mr. PATMAN. Well, when money is tight and folks are going bankrupt all over the Nation including some of my good farmers and ranchers, don't you think it would be more important for us to make sure that their credit needs are taken care of instead of these needs for mergers?

Chairman VOLCKER. In fact, we said that in late 1979 and early 1980; we said precisely that. One of the interesting things about that episode to me was that no sooner did we say it, and say it with increasing intensity during that period, than we began getting comments from the Congress and elsewhere that, "This particular merger was a good one, and you ought to make sure there is financing for it."

It is a complex problem. It depends upon whose ox is being gored as to whether you like a merger or not in some cases.

Mr. PATMAN. Maybe we could pass a concurrent resolution to give you the guidance.

Chairman VOLCKER. I think if we were going to do that kind of thing, we really would need some guidance.

Mr. PATMAN. Thank you, Mr. Chairman, Chairman Volcker.

The CHAIRMAN. Well, as you get closer to Heaven you will not need the guidance because we will have the knowledge of the Almighty.

Chairman VOLCKER. I am not that close.

The CHAIRMAN. At this point, there has been a request forwarded to the Chair to insert a statement by the Honorable George Hansen, a member of the committee, and we will put it in the record at this point.

[The statement follows:]

OPENING STATEMENT OF HON. GEORGE HANSEN
HEARINGS ON THE CONDUCT OF MONETARY POLICY
July 21, 1982

Mr. Chairman:

Since the 1970's, people from all across the country -- from Main Street to Wall Street -- have been devastated by high interest rates, costing them their jobs, their family farms, and their businesses. These people -- our constituents -- seriously wonder if they can depend upon this Government to adhere to its stated policies of noninflationary money growth, reduced Federal spending, and a credible tax program to achieve the goals of full employment and sustained economic growth. Their underlying skepticism, which is focused correctly in my opinion, only adds to the problem of higher-than-necessary interest rates.

Chairman Volcker, we are here to answer at least a few of the many economic questions confronting us today. Can we expect interest rates to continue their downward trend in the future? Can we expect the Federal Reserve to pursue a policy of noninflationary money growth consistent with economic recovery in the months ahead?

In many respects the building blocks for recovery are in place. Inflation -- by anyone's measure -- has declined dramatically in the last year and a half. The basic money supply, although far too volatile in the short-run, is reasonably on target. Short-term interest rates have declined significantly and should continue to decline.

Let us not forget that in December 1980, just before President Reagan took office, the prime rate reached its high of 21½%.

Today that rate stands at 16% -- a full five percentage points lower than when this Administration came into office. Similarly, the three-month T-bill rate averaged 15.7% in December 1980. Last February when you testified, that rate had declined to 13.48%, and yesterday's auction saw that rate slip even further to 11.14%. These rates are still too high, but there is no mistaking that they are declining. These are hopeful signs for future employment and economic growth.

Most of us have criticized the Federal Reserve from time to time. I happen to believe, for example, that the money supply in the short-run is too volatile and, in turn, leads to unnecessary fluctuations in short-term interest rates. The Federal Reserve, to its credit, has been wiggling in the right direction since the last time you appeared, but the size of these wiggles is disturbing. I was pleased, however, to read a report recently issued by the Chairman of the Domestic Monetary Policy Subcommittee, my friend Walter Fauntroy. Among other things, this report confirmed that pumping up the money supply is both unnecessary and unwise.

History has taught us that we can neither spend nor reflate our way out of a recession. The Chairman's report acknowledges this lesson and points out that the Federal Reserve has little room for manuvering in its conduct of monetary policy. "Monetary policy can have a substantial impact on interest rates, but most alternatives to present monetary policy are likely to have an adverse impact and contribute to high rates," Chairman Fauntroy observes; "...in general monetary policy changes cannot be expected to solve the problem of high interest rates." The Chairman's report confirms what many of us have been saying for years, that pumping up the money supply only means more inflation and higher interest rates as a result: "Interest rates now go up almost immediately when money supply rises, because market participants now expect higher future inflation to result in the increase of the money supply."

People across the Nation are looking for answers and remedies to our fiscal problems as well, which is the only real way that pressure can be relieved from the wrong-headed urge to tinker with monetary policy. Chairman Volcker, I know you would welcome more fiscal responsibility on the part of Congress. In my mind, there is a triad of economic policy which must be put in place to get this economy moving in the proper direction. One significant leg of this triad is the effort underway to secure a constitutional amendment to balance the budget. The second important leg of this triad is the effort over the past 18 months to reduce spending as well as the rate of spending to achieve a balanced budget.

The final leg of the triad is a fair and simple tax system (FAST) to ensure adequate revenues for the government. Many economists contend that one-half of the taxable economy is not being collected by the government. In my opinion, a fair tax system, if properly implemented, would bolster revenue by as much as $200 billion, would close the existing deficits, would help to balance the budget, and would lower interest rates.

This FAST program is embodied in my proposal before this Administration, which I have personally discussed with President Reagan. The FAST program calls for: (1) reform of IRS collection practices to remove this aversion the public has for dealing with them, (2) an open season or amnesty program to get people back into the system as full taxpayers, and (3) a flat-rate personal income tax to broaden the base of taxpayers, reduce taxes, and provide once again the adequate revenue to run this government.

In closing, Mr. Chairman, I believe that you have been too reluctant in the past to comment on the proper course for fiscal policy while many people cannot wait to jump on you for your conduct of monetary policy. I would like to give you the opportunity today to comment on what further actions the Congress can take to enforce greater fiscal responsibility and thus make your task in the field of monetary policy a bit easier.

Thank you.

The **Chairman**. Chairman Volcker, I want to thank you for your patience and persistence, and all I can say to the fact that you have stayed here for a little over 3 hours is that there are some of us, including the Chairman up here, who stayed with you, and we appreciate your assistance. Your staff may well be receiving written questions.

Chairman **Volcker**. I think this is part of the process, and an important part, by which we try to be accountable to the Congress. I think it has been useful for us.

The **Chairman**. At least there has been a dialog. I think there are some who might come out thinking it is not really accountability; others feel total accountability. But as you say, it is the process. And with the actions of the Fed and Members of Congress, some will be happy with them and some will be unhappy.

Chairman **Volcker**. That is the way it is, short of heaven. [Laughter.]

The **Chairman**. That is right.

In conclusion, I would state that I would not be a bit surprised if there will not be some members who will be sending written questions, and Bill Stanton and I agreed that all members should have the opportunity to submit questions in writing to the Chairman.

Chairman **Volcker**. We would be happy to answer them.

The **Chairman**. If there are no further questions, the committee stands adjourned.

[Whereupon, at 1:10 p.m., the committee was adjourned, subject to the call of the Chair.]

[The July 20, 1982, report of the Board of Governors of the Federal Reserve System, "Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978," and a statement of the National Association of Realtors before the Senate Committee on Banking, Housing, and Urban Affairs on August 12, 1982, follow:]

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 1982

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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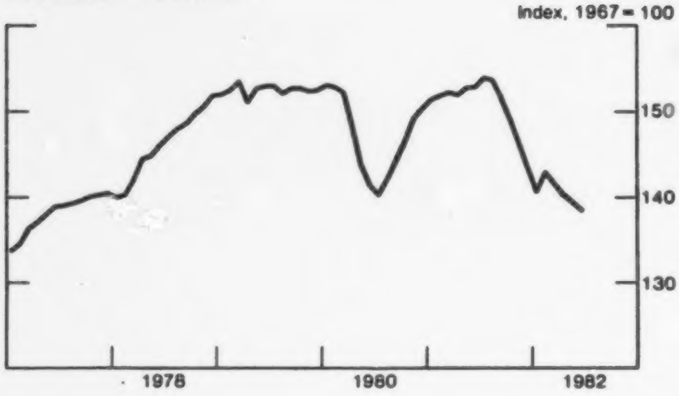
Section 1: The Performance of the Economy in the First Half of 1982

The contraction in economic activity that began in mid-1981 continued into the first half of 1982, although at a diminished pace. Declines in production and employment slowed, while sales of automobiles improved. Real GNP fell at a 4 percent annual rate between the third quarter of 1981 and the first quarter of 1982. With output declining, the margin of unused plant capacity widened and the unemployment rate rose to a postwar record.

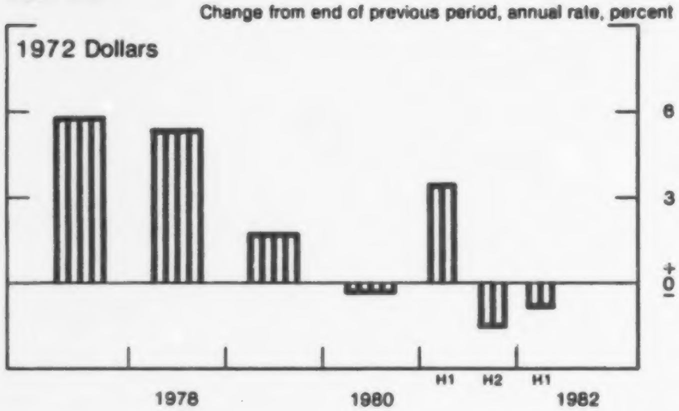
By mid-1982, however, the recession seemed to be drawing to a close. Inventory positions had improved substantially, homebuilding was beginning to revive, and consumer spending appeared to be rising. Nonetheless, there were signs of increased weakness in business investment. Although final demands apparently fell during the second quarter, the rate of inventory liquidation slowed, and on balance, real GNP apparently changed little. If, in fact, this spring or early summer is determined to have been the cyclical trough, both the depth and duration of the decline in activity will have been about the same as in other postwar recessions.

The progress in reducing inflation that began during 1981 continued in the first half of 1982. The greatest improvement was in prices of food and energy--which benefited from favorable supply conditions--but increases in price measures that exclude these volatile items also have slowed markedly. Moreover, increases in employment costs, which carry forward the momentum of inflation, have diminished considerably. Not only have wage increases eased for union workers in hardpressed industries as a result of contract concessions, but wage and fringe benefit increases also have slowed for non-union and white-collar workers in a broad range of

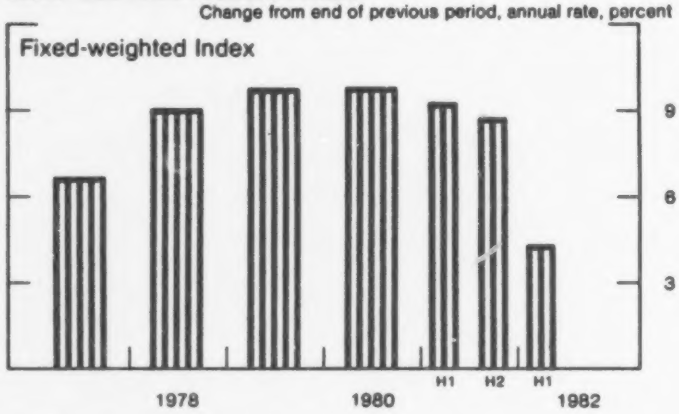
Industrial Production



Real GNP



Gross Business Product Prices

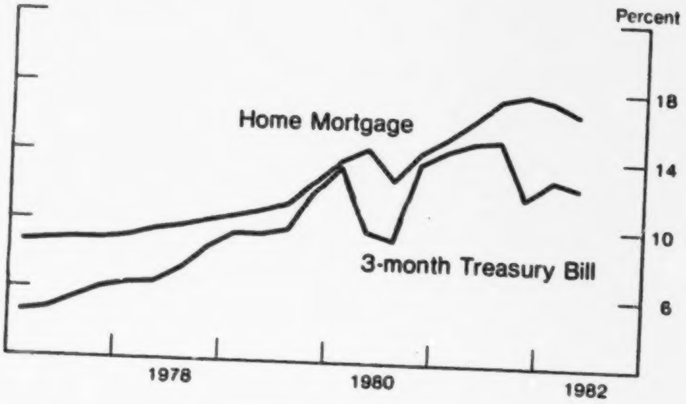


Note: Data for 1982 H1 are partially estimated by the FRB.

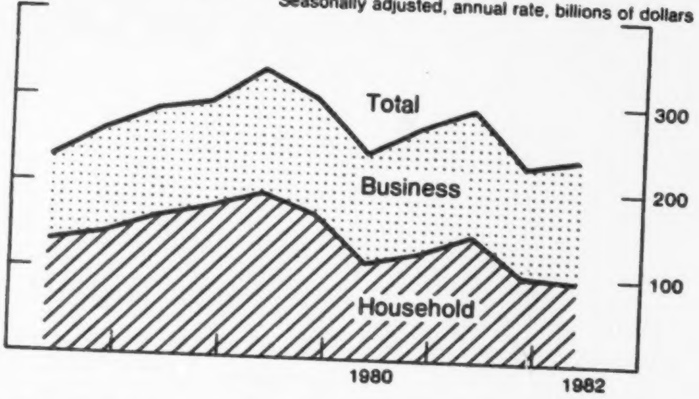
industries. In addition there has been increasing use of negotiated work-rule changes as well as other efforts by business to enhance productivity and trim costs. At the same time, purchasing power has been rising; real compensation per hour increased 1 percent during 1981 and rose at about a 3 percent annual rate over the first half of 1982.

Interest rates. As the recession developed in the autumn of 1981, short-term interest rates moved down substantially. However, part of this decline was retraced at the turn of the year as the demand for money bulged and reserve positions tightened. After the middle of the first quarter, short-term rates fluctuated but generally trended downward, as money--particularly the narrow measure, M1--grew slowly on average and the weakness in economic activity continued. In mid-July, short-term rates were distinctly below the peak levels reached in 1980 and 1981. Nonetheless, short-term rates were still quite high relative to the rate of inflation.

Long-term interest rates also remained high during the first half of 1982. In part, this reflected doubts by market participants that the improved price performance would be sustained over the longer run. This skepticism was related to the fact that, during the past two decades, episodes of reduced inflation have been short-lived, followed by reacceleration to even faster rates of price increase. High long-term rates also have been fostered by the prospect of huge deficits in the federal budget even as the economy recovers. Fears of deepening deficits have affected expectations of future credit market pressures, and perhaps also have sustained inflation expectations. The resolution on the 1983 fiscal year budget that

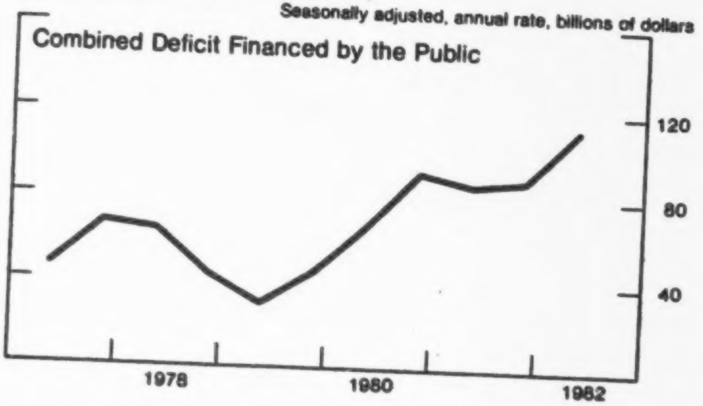


Interest Rates



Funds Raised by Private Nonfinancial Sectors

Seasonally adjusted, annual rate, billions of dollars



Federal Government Borrowing

Seasonally adjusted, annual rate, billions of dollars

Note: Data for 1982 H1 are partially estimated by the FRB.

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was adopted by the Congress represents a beginning effort to deal with the prospect of widening deficits; and the passage of implementing legislation should work in the direction of reducing market pressures on interest rates.

Domestic credit flows. Aggregate credit flows to private nonfinancial borrowers increased somewhat in the first half of 1982 from the reduced pace in the second half of 1981, according to very preliminary estimates. Business borrowing rose while households reduced further their use of credit. Borrowing by the federal government increased sharply in late 1981, after the 5 percent cut in personal income tax rates, and remained near the new higher level during the first half of 1982 on a seasonally adjusted basis. Reflecting uncertainties about the future economic and financial environment, both lenders and borrowers have shown a strong preference for short-term instruments.

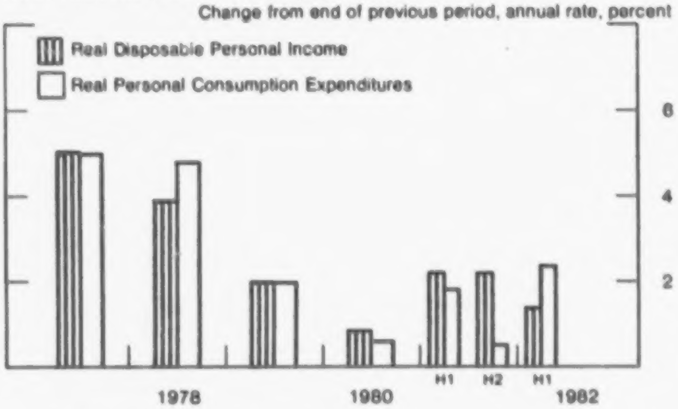
Much of the slackening in credit flows to nonfinancial sectors in the last part of 1981 was accounted for by households, particularly by household mortgage borrowing. Since then, mortgage credit flows have picked up slightly. The advance was encouraged in part by the gradual decline in mortgage rates from the peaks of last fall. In addition, households have made widespread use of adjustable-rate mortgages and "creative" financing techniques--including relatively short-term loans made by sellers at below-market interest rates and builder "buy-downs." About two-fifths of all conventional mortgage loans closed recently were adjustable-rate instruments, and nearly three-fourths of existing home transactions reportedly involved some sort of creative financing.

Business borrowing dropped sharply during the last quarter of 1981, primarily reflecting reduced inventory financing needs. However, credit use by nonfinancial corporations rose significantly in the first half of 1982, despite a further drop in capital expenditures. The high level of bond rates has discouraged corporations from issuing long-term debt, and a relatively large share of business borrowing this year has been accomplished in short-term markets--at banks and through sales of commercial paper. The persistently large volume of business borrowing suggests an accumulation of liquid assets as well as an intensification of financial pressures on at least some firms. Signs of corporate stress continue to mount, including increasing numbers of dividend reductions or suspensions, a rising fraction of business loans at commercial banks with interest or principal past due, and relatively frequent downgradings of credit ratings.

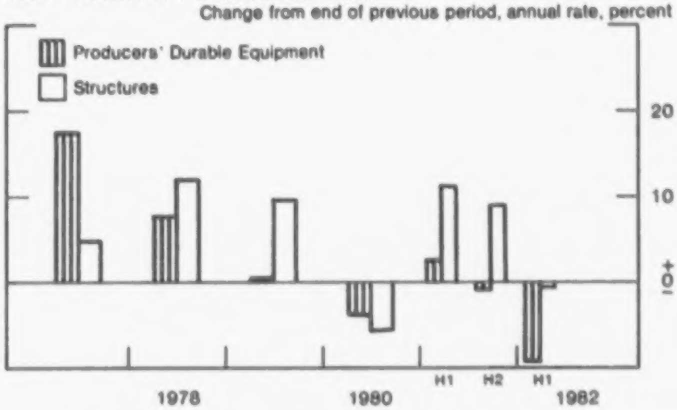
After raising a record volume of funds in U.S. credit markets in 1981, the federal government continued to borrow at an extraordinary pace during the first half of 1982, as receipts (national income and product accounts basis) fell while expenditures continued to rise. Owing to the second phase of the tax cut that went into effect on July 1 and the effects on tax revenues of the recession and reduced inflation, federal credit demands will expand further in the period ahead.

Consumption. Personal consumption expenditures (adjusted for inflation) fell sharply in the fourth quarter of 1981, but turned up early in 1982 and apparently strengthened further during the second quarter. The weakness in consumer outlays during the fourth quarter was concentrated in

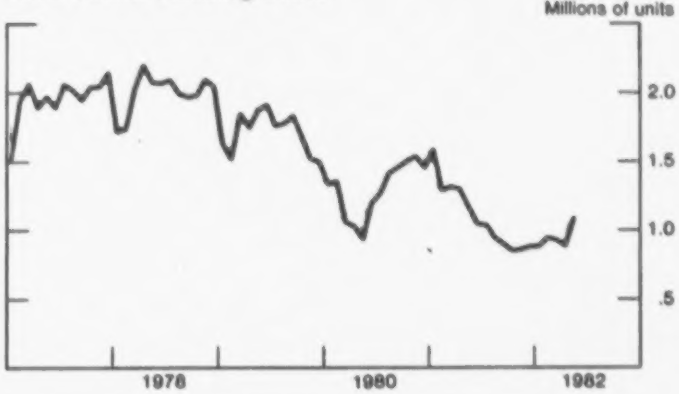
Real Income and Consumption



Real Business Fixed Investment



Total Private Housing Starts



Note: Data for 1982 H1 are partially estimated by the FRB.

the auto sector, as total sales fell to an annual rate of 7.4 million units--the lowest quarterly figure in more than a decade--and sales of domestic models plummeted to a 5.1 million unit rate.

Price rebates and other sales promotion programs during the early months of 1982 provided a fillip to auto demand, and sales climbed to an 8.1 million unit rate. Auto markets remained firm into the spring, boosted in part by various purchase incentives. But as has generally occurred when major promotions have ended, auto purchases fell sharply in June. Outside the auto sector, retail sales at most types of stores were up significantly for the second quarter as a whole. Even purchases at furniture and appliance outlets, which had been on a downtrend since last autumn, increased during the spring.

Real after-tax income has continued to edge up, despite the sharp drop in output during the recession. The advance reflects not only typical cyclical increases in transfer payments but also the reduction in personal income tax rates on October 1. Households initially saved a sizable proportion of the tax cut, boosting the personal saving rate from 5-1/4 percent in mid-1981--about equal to the average of the late 1970s and early 1980s--to 6.1 percent in the fourth quarter of 1981. During early 1982, however, consumers increased spending, partly to take advantage of price markdowns for autos and apparel, and the saving rate fell.

Business investment. As typically occurs during a recession, the contraction in business fixed investment has lagged behind the decline in overall activity. Indeed, even though real GNP dropped substantially during the first quarter of 1982, real spending for fixed business capital actually rose a bit. An especially buoyant element of the investment sector has been outlays for nonfarm buildings--most notably, commercial office buildings, for which appropriations and contracts often are set a year or more in advance.

In contrast to investment in structures, business spending for new equipment showed little advance during 1981 and weakened considerably in the first half of 1982. Excluding business purchases of new cars, which also were buoyed by rebate programs, real investment in producers' durable equipment fell at a 2 percent annual rate in the first quarter. The decline evidently accelerated in the second quarter. In April and May, shipments of nondefense capital goods, which account for about 80 percent of the spending on producers' durable equipment, averaged nearly 3 percent below the first-quarter level in nominal terms. Moreover, sales of heavy trucks dropped during the second quarter to a level more than 20 percent below the already depressed first-quarter average.

Businesses liquidated inventories at a rapid rate during late 1981 and in the first half of 1982. The adjustment of stocks followed a sizable buildup during the summer and autumn of last year that accompanied the contraction of sales. The most prominent inventory overhang by the end of 1981 was in the automobile sector as sales fell precipitously. However, with a combination of production cutbacks and sales promotions, the days' supply of unsold cars on dealers lots had improved considerably by spring.

Manufacturers and non-auto retailers also found their inventories rising rapidly last autumn. Since then, manufacturers as a whole have liquidated the accumulation that occurred during 1981, although some problem areas still exist--particularly in primary metals. Stocks held by non-auto retailers have been brought down from their cyclical peak, but they remain above pre-recession levels.

Residential construction. Housing activity thus far in 1982 has picked up somewhat from the depressed level in late 1981. Housing starts during the first five months of 1982 were up 10 percent on average from the fourth quarter of 1981. The improvement in homebuilding has been supported by strong underlying demand for housing services in most markets and by the continued adaptation of real estate market participants to nontraditional financing techniques that facilitate transactions.

The turnaround in housing activity has not occurred in all areas of the country. In the south, home sales increased sharply in the first part of 1982, and housing starts rose 25 percent from the fourth quarter of 1981. In contrast, housing starts declined further, on average, during the first five months of 1982 in both the west and the industrial north central states.

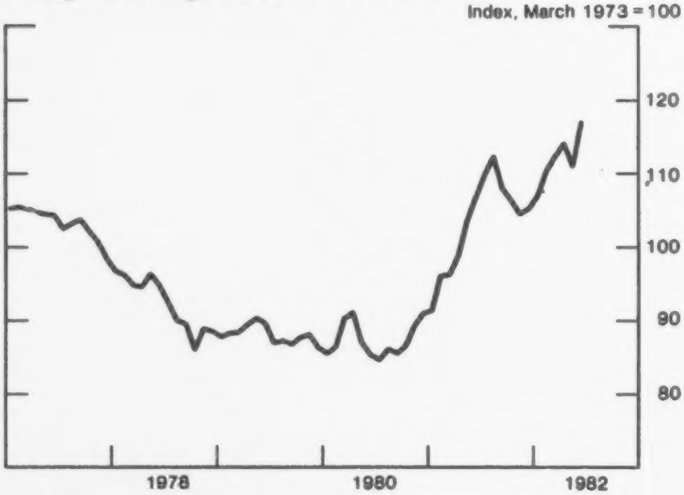
Government. Federal government purchases of goods and services, measured in constant dollars, declined over the first half of 1982. The decrease occurred entirely in the nondefense area, primarily reflecting a sharp drop in the rate of inventory accumulation by the Commodity Credit Corporation during the spring quarter. Purchases by the Commodity Credit Corporation had reached record levels during the previous two quarters owing to last summer's large harvests and weak farm prices. Other nondefense outlays fell slightly over the first half of the year as a result of cuts in employment and other expenditures under many programs. Real defense spending apparently rose over the first half of the year, and the backlog of unfilled orders grew further. The federal deficit on a national income and product account basis widened from $100 billion at the end of 1981 to about $130 billion during the spring of this year. Much of this increase in the deficit reflects the effects of the recession on federal expenditures and receipts.

At the state and local government level, real purchases of goods and services fell further over the first half of 1982 after having declined 2 percent during 1981. Most of the weakness this year has been in construction outlays as employment levels have stabilized after large reductions in the federally funded CETA program led to sizable layoffs last year. The declines in state and local government activity in part reflect fiscal strains associated with the withdrawal of federal support for many activities and the effects of cyclically sluggish income growth on tax receipts. Because of the serious revenue problems, several states have increased sales taxes and excise taxes on gasoline and alcohol.

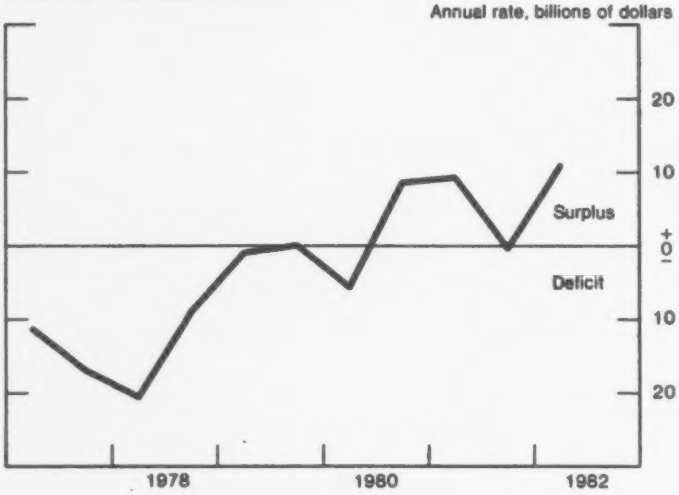
International payments and trade. The weighted-average value of the dollar, after declining about 10 percent from its peak last August, began to strengthen sharply again around the beginning of the year and since then has appreciated nearly 15 percent on balance. The appreciation of the dollar has been associated to a considerable extent with the declining inflation rate in the United States and the rise in dollar interest rates relative to yields on assets denominated in foreign currencies.

Reflecting the effects of the strengthening dollar, as well as the slowing of economic growth abroad, real exports of goods and services have

Foreign Exchange Value of the U.S. Dollar



Current Account Balance



Note: Data for 1982 H1 are partially estimated by the FRB.

been decreasing since the beginning of 1981. The volume of imports other than oil, which rose fairly steadily throughout last year, dropped sharply in the first half of 1982, owing to the weakness of aggregate demand--especially for inventories--in the United States. In addition, both the volume and price of imported oil fell during the first half of the year. The current account, which was in surplus for 1981 as a whole, recorded another surplus in the first half of this year as the value of imports fell more than the value of exports.

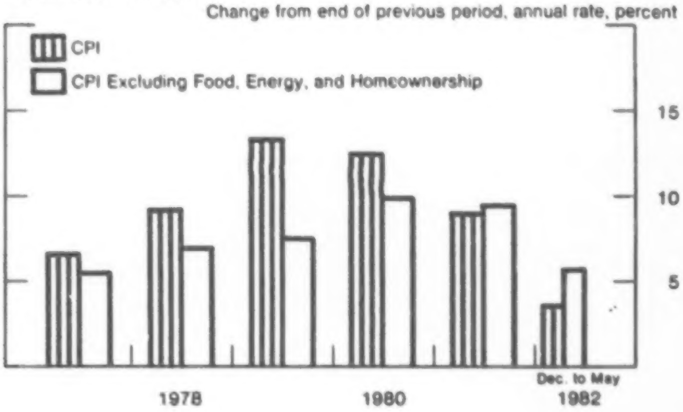
Labor markets. Employment has declined by nearly 1-1/2 million since the peak reached in mid-1981. As usually happens during a cyclical contraction, the largest job losses have been in durable goods manufacturing industries--such as autos, steel, and machinery--as well as at construction sites. The job losses in manufacturing and construction during this recession follow a limited recovery from the 1980 recession; as a result, employment levels in these industries are more than 10 percent below their 1979 highs. In addition, declines in aggregate demand have tempered the pace of hiring at service industries and trade establishments over the past year. As often happens near a business cycle trough, employment fell faster than output in early 1982 and labor productivity showed a small advance after declining sharply during the last half of 1981.

Since mid-1981 there has been a 2-1/4 percentage point rise in the overall unemployment rate to a postwar record high of 9-1/2 percent. The effects of the recession have been most severe in the durable goods and construction industries, and the burden of rising unemployment has been relatively heavy on adult men, who tend to be more concentrated in these industries. At the same time, joblessness among young and inexperienced workers remains extremely high; hardest hit have been black male teenagers who experienced an unemployment rate of nearly 60 percent in June 1982.

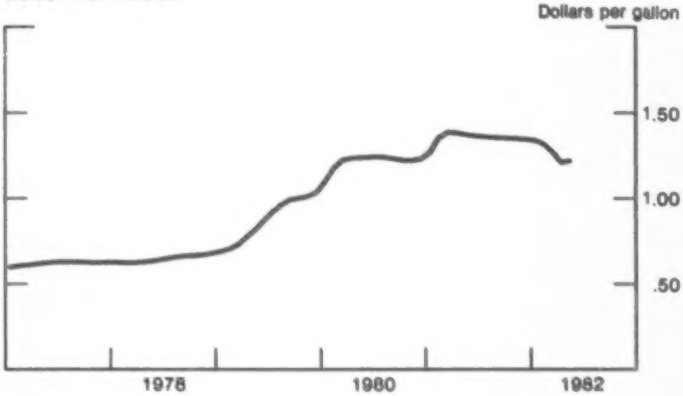
Reflecting the persistent slack in labor markets, most indicators of labor supply also show a significant weakening. For example, the number of discouraged workers--that is, persons who report that they want work but are not looking for jobs because they believe they cannot find any--has increased by nearly half a million over the past year, continuing an upward trend that began before the 1980 recession. In addition, the labor force participation rate--the proportion of the working-age population that is employed or actively seeking jobs--has been essentially flat for the last two years after rising about one-half percentage point annually between 1975 and 1979.

Prices and labor costs. A slowing in the pace of inflation, which was evident during 1981, continued through the first half of this year. During the first five months of 1982 (the latest data available), the consumer price index increased at an annual rate of 3.5 percent, sharply lower than the 8.9 percent rise during 1981. Much of the improvement was in energy and food prices as well as in the volatile CPI measure of homeownership costs. But even excluding these items, the annual rate of increase in consumer prices has slowed to 5-1/2 percent this year compared with a 9-1/2 percent rise last year. The moderation of price increases also was evident at the producer level. Prices of capital equipment have increased at a 4-1/4 percent annual rate thus far this year--well below the 9-1/4 percent pace of 1981. In addition, the decline in raw materials prices, which occurred throughout last year, has continued in the first half of 1982.

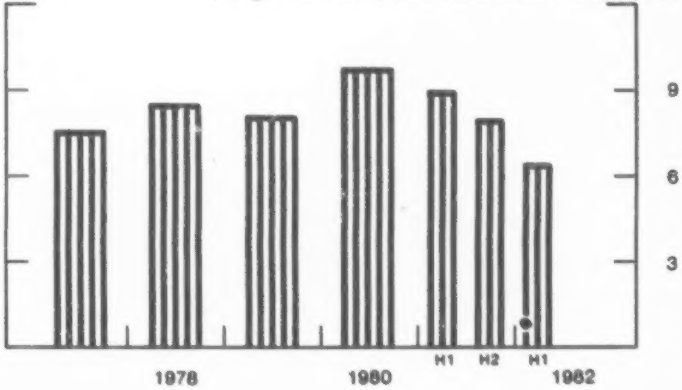
Consumer Prices



Gasoline Prices



Hourly Earnings Index



Gasoline prices at the retail level, which had remained virtually flat over the second half of 1981, fell substantially during the first four months of 1982. Slack domestic demand and an overhang of stocks on world petroleum markets precipitated the decline in prices. However, gasoline prices began to rise again in May in reflection of rising consumption, reduced stocks, and lower production schedules by major crude oil suppliers.

The rate of increase in employment costs decelerated considerably during the first half of 1982. The index of average hourly earnings, a measure of wage trends for production and nonsupervisory personnel, rose at a 6-1/4 percent annual rate over the first half of this year, compared with an increase of 8-1/4 percent during 1981. Part of the slowing was due to early negotiation of expiring contracts and renegotiation of existing contracts in a number of major industries. These wage concessions are expected to relieve cost pressures and to enhance the competitive position of firms in these industries. Increases in fringe benefits, which generally have risen faster than wages over the years, also are being scaled back. Because wage demands, not to mention direct escaltor provisions, are responsive to price performance, the progress made in reducing the rate of inflation should contribute to further moderation in labor cost pressures.

Section 2: The Growth of Money and Credit in the First Half of 1982

The annual targets for the monetary aggregates announced in February were chosen to be consistent with continued restraint on the growth of money and credit in order to exert sustained downward pressure on inflation. At the same time, these targets were expected to result in sufficient money growth to support an upturn in economic activity. Measured from the fourth quarter of 1981 to the fourth quarter of 1982, the growth ranges for the aggregates adopted by the Federal Open Market Committee (FOMC) were as follows: for M1, 2-1/2 to 5-1/2 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The corresponding range specified by the FOMC for bank credit was 6 to 9 percent.[1]

When the FOMC was deliberating on its annual targets in February, the Committee was aware that M1 already had risen well above its average level in the fourth quarter of 1981. In light of the financial and economic backdrop against which the bulge in M1 had occurred, the Committee believed it likely that there had been an upsurge in the public's demand for liquidity. It also seemed probable that this strengthening of money demand would unwind in the months ahead. Thus, under these circumstances and given the relatively low base for the M1 range for 1982, it did not appear appropriate to seek an abrupt return to the annual target range, and the FOMC indicated its willingness to permit M1 to remain above the range for a while. At the same time, the FOMC agreed that the expansion in M1 for the year as a whole might appropriately be in the upper part of its range, particularly if available evidence suggested the persistence of unusual desires for liquidity that had to be accommodated to avoid undue financial stringency.

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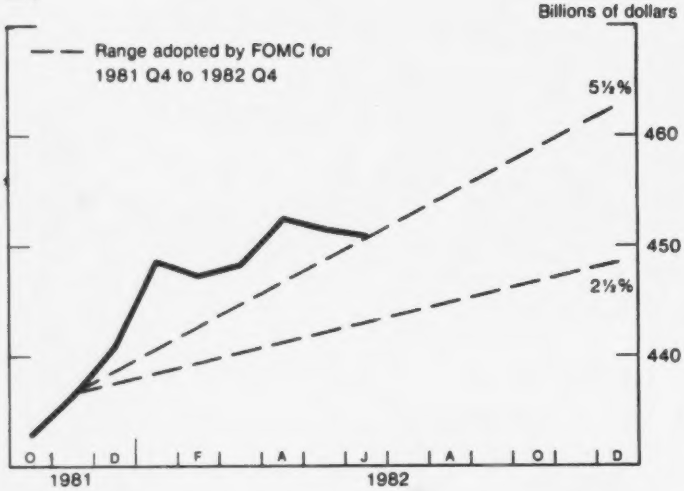
[1] Because of the authorization of international banking facilities (IBFs) on December 3, 1981, the bank credit data starting in December 1981 are not comparable with earlier data. The target for bank credit was put in terms of annualized growth measured from the average of December 1981 and January 1982 to the average level in the fourth quarter of 1982 so that the shift of assets to IBFs that occurred at the turn of the year would not have a major impact on the pattern of growth.

In setting the annual target for M2, the FOMC indicated that M2 growth for the year as a whole probably would be in the upper part of its annual range and might slightly exceed the upper limit. The Committee anticipated that demands for the assets included in M2 might be enhanced by new tax incentives such as the broadened eligibility for IRA/Keogh accounts, or by further deregulation of deposit rates. The Committee expected that M3 growth again would be influenced importantly by the pattern of business financing and, in particular, by the degree to which borrowing would be focused in markets for short-term credit.

As anticipated--and consistent with the FOMC's short-run targets--the surge in M1 growth in December and January was followed by appreciably slower growth. After January, M1 increased at an annual rate of only 1-1/4 percent on average, and the level of M1 in June was only slightly above the upper end of the Committee's annual growth range. From the fourth quarter of 1981 to June, M1 increased at a 5.6 percent annual rate. M2 growth so far this year also has run a bit above the FOMC's annual range; from the fourth quarter of 1981 through June, M2 increased on average at a 9.4 percent annual rate. From a somewhat longer perspective, M1 has increased at a 4.7 percent annual rate, measuring growth from the first half of 1981

Ranges and Actual Monetary Growth

M1



Annual Rates of Growth

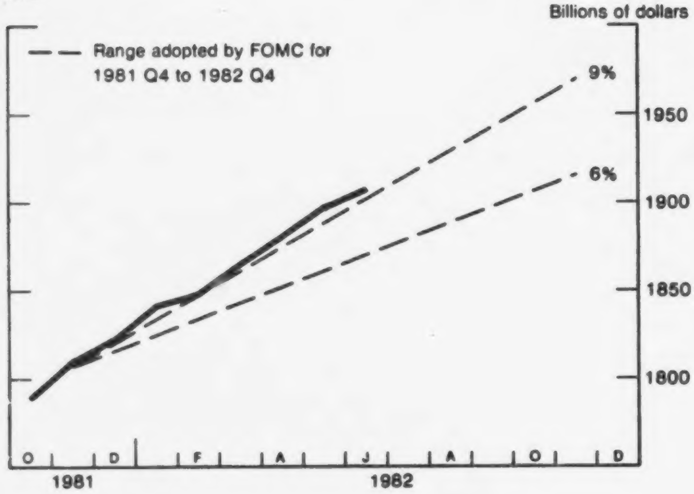
1981 Q4 to June
5.6 Percent

1981 Q4 to 1982 Q2
6.8 Percent

1981 H1 to 1982 H1
4.7 Percent[1]

[1] Adjusted for shifts into new NOW accounts in 1981.

M2



Annual Rates of Growth

1981 Q4 to June
9.4 Percent

1981 Q4 to 1982 Q2
9.7 Percent

1981 H1 to 1982 H1
9.7 Percent

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to the first half of 1982 and abstracting from the shift into NOW accounts in 1981; and M2 has grown at a 9.7 percent annual rate on a half-year over half-year basis.

Although M1 growth has been moderate on balance thus far this year, that growth has considerably exceeded the pace of increase in nominal GNP. Indeed, the first-quarter decline in the income velocity of M1--that is, GNP divided by M1--was extraordinarily sharp. Similarly, the velocity of the broader aggregates has been unusually weak. Given the persistence of high interest rates, this pattern of velocity behavior suggests a heightened demand for M1 and M2 over the first half.

The unusual demand for M1 has been focused on its NOW account component. Following the nationwide authorization of NOW accounts at the beginning of 1981, the growth of such deposits surged. When the aggregate targets were reviewed this past February, a variety of evidence indicated that the major shift from conventional checking and savings accounts into NOW accounts was over; in particular, the rate at which new accounts were being opened had dropped off considerably. As a result of that shift, however, NOW accounts and other interest-bearing checkable deposits had grown to account for almost 20 percent of M1 by the beginning of 1982. Subsequently, it has become increasingly apparent that M1 is more sensitive to changes in the public's desire to hold highly liquid assets.

M1 is intended to be a measure of money balances held primarily for transaction purposes. However, in contrast to the other major components of M1--currency and conventional checking accounts--NOW accounts also have some characteristics of traditional savings accounts. Apparently reflecting precautionary motives to a considerable degree, NOW accounts and other interest-bearing checkable deposits grew surprisingly rapidly in the fourth quarter of last year and the first quarter of this year. Although growth in this component has slowed recently, its growth from the fourth quarter of last year to June has been 30 percent at an annual rate. The other components of M1 increased at an annual rate of less than 1 percent over this same period.

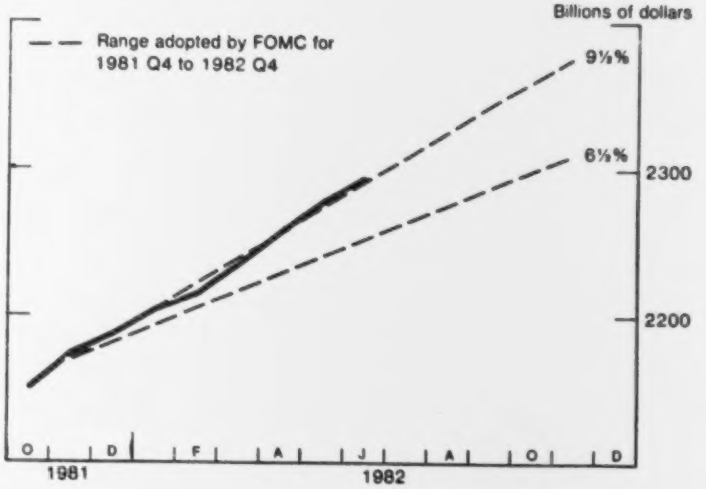
Looking at the components of M2 not also included in M1, the so-called nontransaction components, these items grew at a 10-3/4 percent annual rate from the fourth quarter to June. General purpose and broker/dealer money market mutual funds were an especially strong component of M2, increasing at almost a 30 percent annual rate this year. Compared with last year, however, when the assets of such money funds more than doubled, this year's increase represents a sharp deceleration.

Perhaps the most surprising development affecting M2 has been the behavior of conventional savings deposits. After declining in each of the past four years--falling 16 percent last year--savings deposits have increased at about a 4 percent annual rate thus far this year. This turnaround in savings deposit flows, taken together with the strong increase in NOW accounts and the still substantial growth in money funds, suggests that stronger preferences to hold safe and highly liquid financial assets in the current recessionary environment are bolstering the demand for M2 as well as M1.

M3 increased at a 9.7 percent annual rate from the fourth quarter of 1981 to June, just above the upper end of the FOMC's annual growth target.

Ranges and Actual Monetary Growth

M3



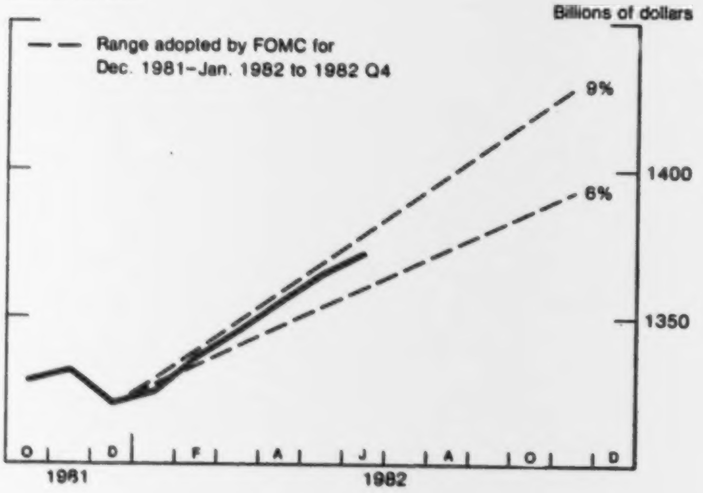
Annual Rates of Growth

1981 Q4 to June
9.7 Percent

1981 Q4 to 1982 Q2
9.8 Percent

1981 H1 to 1982 H1
10.5 Percent

Bank Credit



Annual Rates of Growth

Dec.-Jan. to June
8.0 Percent

Dec.-Jan. to 1982 Q2
8.3 Percent

1981 H1 to 1982 H1
8.4 Percent[1]

[1] Adjusted for initial shifts into international banking facilities.

Early in the year, M3 growth was relatively moderate as a strong rise in large-denomination CDs was offset by declines in term RPs and in money market mutual funds restricted to institutional investors. During the second quarter, however, M3 showed a larger increase; the weakness in its term RP and money fund components subsided and heavy issuance of large CDs continued. With growth of "core deposits" relatively weak on average, commercial banks borrowed heavily in the form of large CDs to fund the increase in their loans and investments.

Commercial bank credit grew at an 8.3 percent annual rate over the first half of the year, in the upper part of the FOMC's range for 1982. Bank loans have increased on average at about a 9-1/2 percent annual rate, with loans to nonfinancial businesses expanding at a 14 percent annual rate. In past economic downturns, business loan demand at banks has tended to weaken, but consistently high long-term interest rates in the current recession have induced corporations to meet the great bulk of their external financing needs through short-term borrowing. Real estate loans have increased at a 7-1/4 percent annual rate this year, somewhat slower than the growth in each of the past two years. Consumer loans outstanding during the first half of the year have grown at the same sluggish pace of 3 percent experienced last year. The investment portfolios of banks have expanded at about a 5 percent annual rate, with the rate of increase in U.S. government obligations about twice as large as the growth in holdings of other types of securities.

Section 3: The Federal Reserve's Objectives for Growth of Money and Credit

There is a clear need today to promote higher levels of production and employment in our economy. The objective of Federal Reserve policy is to create an environment conducive to sustained recovery in business activity while maintaining the financial discipline needed to restore reasonable price stability. The experience of the past two decades has amply demonstrated the destructive impact of inflation on economic performance. Because inflation cannot persist without excessive monetary expansion, appropriately restrained growth of money and credit over the longer run is critical to achieving lasting prosperity.

The policy of firm restraint on monetary growth has contributed importantly to the recent progress toward reducing inflation. But when inflationary cost trends remain entrenched, the process of slowing monetary growth can entail economic and financial stresses, especially when so much of the burden of dealing with inflation rests on monetary policy. These strains--reflected in reduced profits, liquidity problems, and balance-sheet pressures--place particular hardships on industries that depend heavily on credit markets such as construction, business equipment, and consumer durables.

Unfortunately, these stresses cannot be easily remedied through accelerated money growth. The immediate effect of encouraging faster growth in money might be lower interest rates, especially in short-term markets. In time, however, the attempt to drive interest rates lower through a substantial reacceleration of money growth would founder, for the result would be to embed inflation and expectations of inflation even more deeply into the nation's economic system. It would mean that this recession was another wasted, painful episode instead of a transition to a sustained improvement in the economic environment. The present and prospective pressures on financial markets urgently need to be eased not by relaxing discipline on money growth, but by the adoption of policies that will ensure a lower and declining federal deficit. Moreover, a return to financial health will require the adoption of more prudent credit practices on the part of private borrowers and lenders alike.

In reviewing its targets for 1982 and setting tentative targets for 1983, the FOMC had as its basic objective the maintenance of the longer-range thrust of monetary discipline in order to reduce inflation further, while providing sufficient money growth to accommodate exceptional liquidity pressures and support a sustainable recovery in economic activity. At the same time, the Committee recognized that regulatory actions or changes in the public's financial behavior might alter the implications of any quantitative monetary goals in ways that cannot be fully predicted.

In light of all these considerations, the Committee concluded that a change in the previously announced targets was not warranted at this time. Because of the tendency for the demand for money to run strong on average in the first half, and also responding to the congressional budget resolution, careful consideration was given to the question of whether some raising of the targets was in order. However, the available evidence did not suggest that a large increase in the ranges was justified, and a small change in the ranges would have represented a degree of "fine tuning" that appeared inconsistent with the degree of uncertainty surrounding the precise relationship of money to other economic variables at this time. However, the Committee concluded, based on current evidence, that growth this year around the top of the ranges for the various aggregates would be acceptable.

The Committee also agreed that possible shifts in the demand for liquidity in current economic circumstances might require more than ordinary elements of flexibility and judgment in assessing appropriate needs for money in the months ahead. In the near term, measured growth of the aggregates may be affected by the income tax reductions that occurred on July 1, by cost-of-living increases in social security benefits, and by the ongoing difficulties of accurately accounting for seasonal movements in the money stock. But more fundamentally, it is unclear to what degree businesses and households may continue to wish to hold unusually large precautionary liquid balances. To the extent the evidence suggests that relatively strong precautionary demands for money persist, growth of the aggregates somewhat above their targeted ranges would be tolerated for a time and still would be consistent with the FOMC's general policy thrust.

Looking ahead to 1983 and beyond, the FOMC remains committed to restraining money growth in order to achieve sustained noninflationary economic expansion. At this point, the FOMC feels that the ranges now in effect can appropriately remain as preliminary targets for 1983. Because monetary aggregates in 1982 more likely than not will be close to the upper ends of their ranges, or perhaps even somewhat above them, the preliminary 1983 targets would be fully consistent with a reduction in the actual growth of money in 1983.

In light of the unusual uncertainty surrounding the economic, financial, and budgetary outlook, the FOMC stressed the tentative nature of its 1983 targets. On the one hand, postwar cyclical experience strongly suggests that some reversal of this year's unusual shift in the asset-holding preferences of the public could be expected; with economic activity on an upward trend, any lingering precautionary motives for holding liquid balances should begin to fade, thus contributing to a rapid rise in the velocity of money. Moreover, regulatory actions by the Depository Institutions Deregulation Committee that increase the competitive appeal of deposit instruments--as well as the more widespread use of innovative cash management techniques, such as "sweep" accounts--also could reduce the demand for money relative to income and interest rates. On the other hand, factors exist that should increase the attractiveness of holding cash balances. The long upward trend in the velocity of money since the 1950s took place in an environment of rising inflation and higher nominal interest rates--developments that provide incentives for economizing on money holdings. As these incentives recede, it is possible that the attractiveness of cash holdings will be enhanced and that more money will be held relative to the level of business activity.

Section 4: The Outlook for the Economy

The economy at midyear appears to have leveled off after sizable declines last fall and winter. Consumption has strengthened with retail sales up significantly in the second quarter. New and existing home sales have continued to fluctuate at depressed levels, but housing starts nonetheless have edged up. In the business sector, substantial progress has been made in working off excess inventories, and the rate of liquidation appears to have declined. On the negative side, however, plant and equipment spending, which typically lags an upturn in overall activity, is still depressed. And the trend in export demand continues to be a drag on the economy, reflecting the dollar's strength and weak economic activity abroad.

An evaluation of the balance of economic forces indicates that an upturn in economic activity is highly likely in the second half of 1982. Monetary growth along the lines targeted by the FOMC should accommodate this expansion in real GNP, given the increases in velocity that typically occur early in a cyclical recovery and absent an appreciable resurgence of inflation. The 10 percent cut in income tax rates that went into effect July 1 is boosting disposable personal income and should reinforce the growth in consumer spending. Given the improved inventory situation, any sizable increase in consumer spending should, in turn, be reflected in new orders and a pickup in production. Another element supporting growth in real GNP will be the continuing rise in defense spending and the associated private investment outlays needed for the production of defense equipment.

At least during the initial phase, the expansion is likely to be more heavily concentrated in consumer spending than in past business cycles, as current pressures in financial markets and liquidity strains may inhibit the recovery in investment activity. With mortgage interest rates high, residential construction does not seem likely to contribute to the cyclical recovery to the extent that it has in the past. Likewise, the high level of corporate bond rates, and the cumulative deterioration in corporate balance sheets resulting from reliance in recent years on short-term borrowing, may restrain capital spending, especially given the considerable margin of unutilized capacity that now exists.

The excellent price performance so far this year has been helped by slack demand and by exceptionally favorable energy and food supply developments. For that reason, the recorded rate of inflation may be higher in the second half. However, prospects appear excellent for continuing the downtrend in the underlying rate of inflation. As noted earlier, significant progress has been made in slowing the rise in labor compensation, and improvement in underlying cost pressures should continue over the balance of the year. Unit labor costs also are likely to be held down by a cyclical rebound in productivity growth as output recovers. Moreover, lower inflation will contribute to smaller cost-of-living wage adjustments, which will moderate cost pressures further.

The Federal Reserve's objectives for money growth through the end of 1983 are designed to be consistent with continuing recovery in economic activity. A critical factor influencing the composition and strength of the expansion will be the extent to which pressures in financial markets moderate. This, in turn, depends importantly on the progress made in further reducing inflationary pressures. A marked decrease in inflation would take pressure off financial markets in two ways. First, slower inflation will lead to a reduced growth in transaction demands for money, given any particular level of real activity. It follows that a given target for money growth can be achieved with less pressure on interest rates and accordingly less restraint on real activity, the greater is the reduction in inflation. Second, further progress in curbing inflation will help lower long-term interest rates by reducing the inflation premium contained in nominal interest rates. The welcome relief in inflation seen recently apparently is assumed by many to represent a cyclical rather than a sustained drop in inflation. But the longer that improved price performance is maintained, the greater will be the confidence that a decisive downtrend in inflation is being achieved. Such a change should be reflected in lower long-term interest rates and stronger activity in the interest-sensitive sectors of the economy.

Another crucial influence on financial markets and thus on the nature of the expansion in 1983 will be the federal budgetary decisions that are made in coming months. The budget resolution that was recently passed by the House and Senate is a constructive first step in reducing budget deficits as the economy recovers. However, much remains to be done in appropriation and revenue legislation to implement this resolution. How the budgetary process unfolds will be an important factor in determining future credit demands by the federal government and thus the extent to which deficits will preempt the net savings generated by the private economy. A strong program of budget restraint would minimize pressures in financial markets and thereby enhance the prospects for a more vigorous recovery in homebuilding, business fixed investment, and other credit-dependent sectors.

In assessing the economic outlook, the individual members of the FOMC have formulated projections for several key measures of economic performance that fall generally within the ranges in the table below. In addition to the monetary aggregate objectives discussed earlier, these projections assume that the federal budget will be put on a course that over time will result in significant reductions in the federal deficit.

ECONOMIC PROJECTIONS OF FOMC MEMBERS

	Actual	Projected	
	1981	1982	1983
Changes, fourth quarter to fourth quarter, percent			
Nominal GNP	9.8	5-1/2 to 7-1/2	7 to 9-1/2
Real GNP	0.9	1/2 to 1-1/2	2-1/2 to 4
GNP deflator	8.9	4-3/4 to 6	4 to 5-3/4
Average level in the fourth quarter, percent			
Unemployment rate	8.3	9 to 9-3/4	8-1/2 to 9-1/2

Revised administration forecasts for the economy were not available at the time of the Committee's deliberation. Our understanding, however, is that the administration's midyear budgetary review will be presented within the framework of the economic assumptions used in the first budget resolution. For the remainder of 1982, those assumptions imply somewhat more rapid recovery than the range now thought most likely by members of the FOMC, but would be consistent with the monetary targets outlined in this report on the assumption of growth in velocity characteristic of the early stages of a number of past recoveries. Looking further ahead, the Committee members, like the administration and the Congress, foresee continued economic expansion in 1983, but currently anticipate a less rapid rate of price increase and somewhat slower real growth than the assumptions underlying the budget. The monetary targets tentatively set for 1983, which will be reviewed early next year, would imply, under the budgetary assumptions, relatively high growth in velocity.

STATEMENT
on behalf of
NATIONAL ASSOCIATION OF REALTORS ®
regarding
MONETARY POLICY
to the
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
by
DR. JACK CARLSON
August 12, 1982

I am Jack Carlson, Executive Vice President and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS ®.

On behalf of the nearly 600,000 members of the National Association, we greatly appreciate the opportunity to submit our views on the Monetary Policy.

RECOMMENDATIONS

(1) We recommend this Committee consider instructing the Federal Reserve to use short-term interest targets in addition to and consistent with money growth targets, particularly during periods of time when the appropriate long and short-term monetary growth targets of the Federal Reserve are being met.

(2) We recommend to this committee that it consider recommending to the Federal Reserve that in view of the fact that reductions in money velocity have caused the monetary targets to be increasingly restrictive, the Federal Reserve should consider modifying the money growth targets upward during these periods of reduced money velocity. It is our recommendation that the targets can and should be increased by one percentage point for the remainder of this year and for 1963.

(3) We recommend to this committee that it encourage the Federal Reserve to set a suitable date for implementation of contemporaneous reserve accounting.

(4) We recommend to this committee that it recommend to the Federal Reserve that reducing information by which expectations on the short run money growth policy of the Open Market Committee are formed in the financial markets through averaging the weekly money stock measures is an inappropriate response to the problem of the formation of erroneous expectations. The plan to implement the averaging of the money stock measures should be cancelled. The Federal Reserve should implement measures to increasre the information by which these expectations are formed and not reduce it.

(5) We recommend to this committee that it request the Federal Reserve to consider holding monthly briefings in New York

and Washington for financial market economists, practitioners, and others whose opinions weigh heavily in the formation of investor expectations and report to the committee as to the feasibility of this proposal. The purpose of the briefing would be to reduce erroneous policy expectations in the financial markets particularly as they relate to factors that influence short and medium term policy modifications by the Open Market Committee.

SUMMARY

(1) Since late in 1979, major elements of Federal Economic Policy have been in direct conflict in that the Federal Reserve has pursued on anti-inflationary policy of credit restraint while the Congress and the Administration have pursued an inflationary policy of fiscal stimulation to increase economic growth and employment.

(2) The result of this policy mix is an unusual set of economic conditions, i.e., lower inflation, higher unemployment, and stagnant economic growth co-existing with high and volatile interest rates.

(3) High and volatile interest rates, by keeping the housing and auto industries, business investment and trade in goods and services depressed is preventing economic recovery and has inflationary implications for the future.

(4) We agree with Federal Reserve Chairman Volcker that there has to be far more done on the fiscal side in reducing deficits before a sustained and robust economic recovery can ensue.

(5) Interest rate volatility is known to be a major factor in depressing credit dependent industries. This rate volatility has primarily been the result of an erratic growth path for money supply as represented by M1. The Federal Reserve's capacity to control the supply of credit in order to produce a steadily growing money supply is limited.

(6) The Federal Reserve should adopt, as has been recommended by its own staff, a contemporaneous reserve requirement system in order that they have greater short run accuracy in managing reserves to meet money growth objectives.

(7) The current economic conditions have confused the expectations of investors and consumers and they have responded to this by holding large amounts of liquid assets. This has caused changes in money velocity that have necessitated policy modifications by the Federal Reserve with respect to the monetary growth targets.

(8) These policy modifications have not been effectively communicated to the financial markets and have resulted in erroneous monetary policy anticipations by the markets. Interest rates have, therefore, been higher during the early part of 1982 than they would have been if policy expectations had been more accurate.

(9) The Federal Reserve should implement measures to reduce erroneous policy expectations in the financial markets, particularly as it relates to factors that influence short- and medium-term policy modifications with respect to monetary growth targets.

(10) The economy is now poised for recovery and with inflation currently reduced the Federal Reserve should shift its priority from reducing inflation to encouraging economic growth. It now can safely allow money to grow at least one percentage point above the current target range. This is particularly the case with current high liquidity preferences and low money velocity. The result of this would be to further lower interest rates and relieve some of the pressure from the interest sensitive industries and thrift institutions. A more rapid economic recovery would result from this policy change.

Since late in 1979, the Federal Reserve has pursued a policy of bank reserve management for the purpose of regulating the growth rates of several monetary aggregates within prespecified annual target ranges. The policy was adopted as an approach toward reducing inflation by limiting the growth of nominal GNP. The theoretical justification is that, although there will be short-run impact on real output and employment from restraining money growth, the intermediate and long-term adjustment would primarily come out of the inflation component of nominal GNP which is the desired result. At the time, reducing inflation, which was growing during some months at annualized rates in excess of eighteen percent, had acquired a national constituency for making it the primary domestic policy priority.

Although the path of growth in the money aggregates has been volatile, their yearly growth has steadily declined over 1980, 1981, and the first half of 1982; and as consistent with theory, inflation has significantly declined. However, theory also suggests that interest rates should have declined with the reduction of inflation and the slowing of real output growth. This has not occurred. Interest rates and, particularly real interest rates, have reached and maintained record highs.

Figure 1

INFLATION AND INTEREST RATES

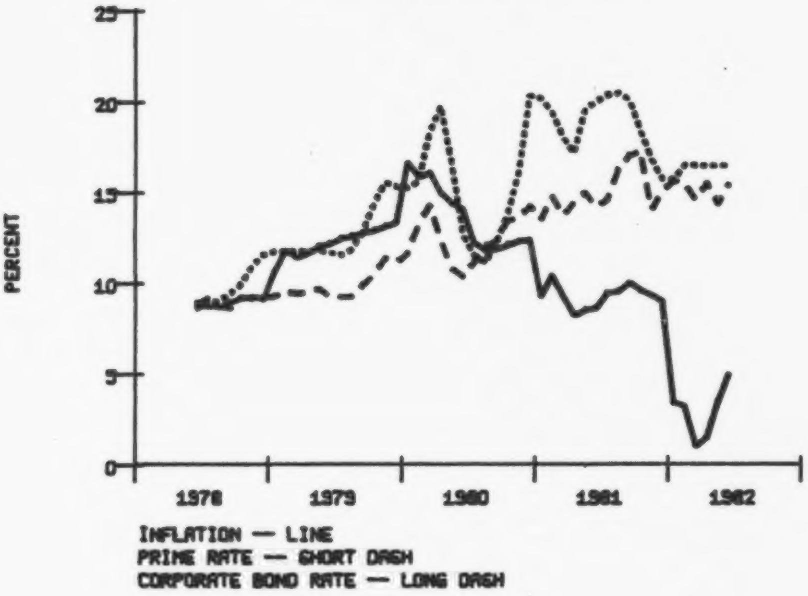


Figure 2

PERCENT CHANGE IN REAL GNP

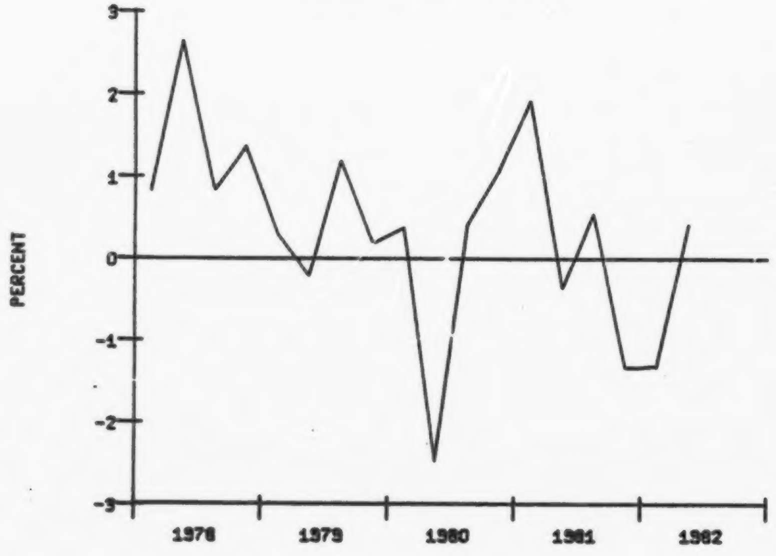


Figure 3

UNEMPLOYMENT RATE

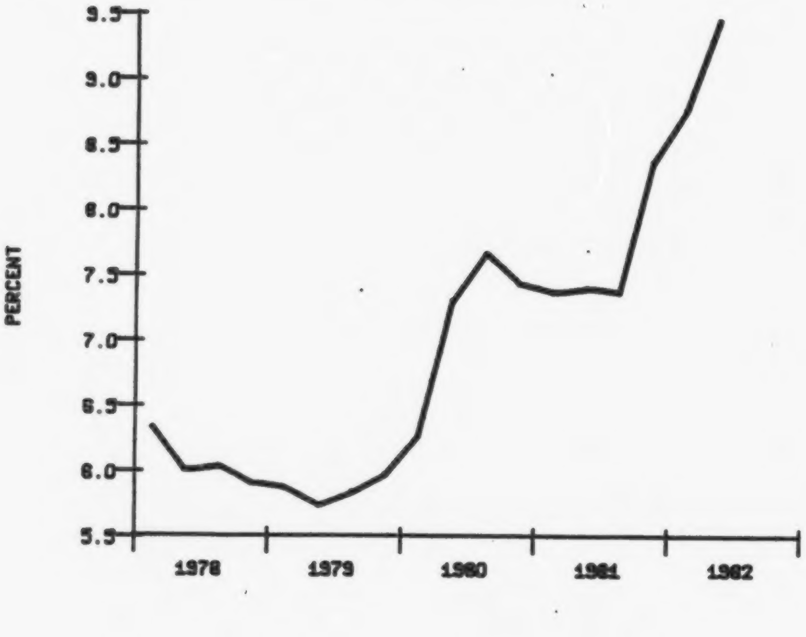


Figure 4

M1 GROWTH COMPARED TO TARGETS

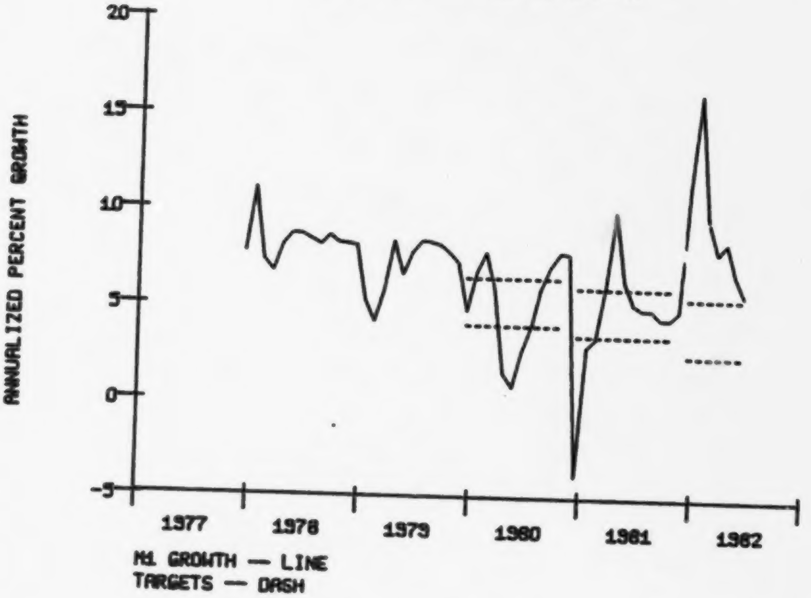
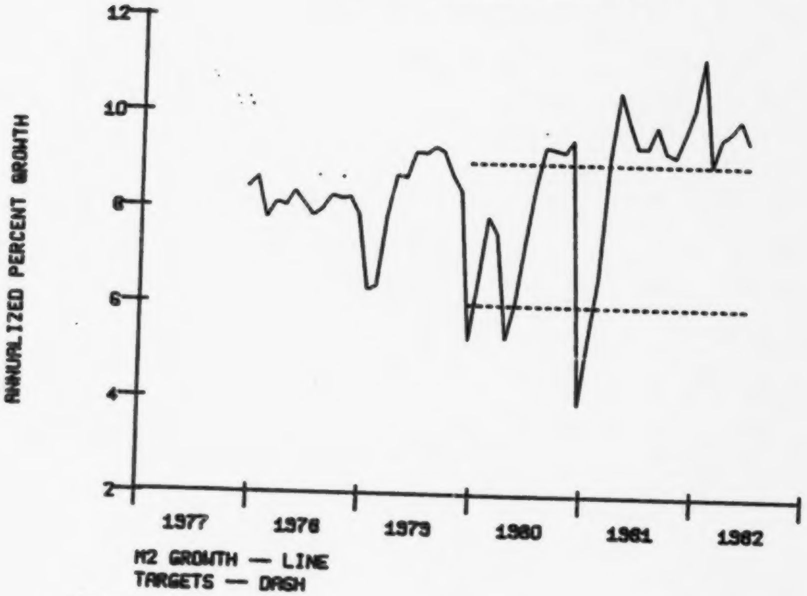


Figure 5

M2 GROWTH COMPARED TO TARGETS



The primary reason for this departure from theoritical expectations is that while the Federal Reserve was pursuing an anti-inflationary policy of credit restraint, successive Congresses and Administrations have direcly contradicted this by pursuing a policy of fiscal stimulation to increase economic growth and employment. Because the demand for money generated by the large and accelerating borrowing requirements resulting from this fiscal stimulation is large relative to available money, and does not depend on levels of output and cost of funds, the private demand for money had to carry the burden of adjustment to this conflict in policy. Interest rates remain high, contrary to the expectations of theory, because the assumption in theory that the demand for money depends on the price of money and levels of economic output has not held. The high interest rates we currently suffer are in place to effect the downward adjustment in private demands for money in order that the large and growing public demand for money can be accommodated despite the policy of deceleration in money growth being implemented by the Federal Reserve. This conflict in Federal fiscal and monetary policy has currently left us with an unusual set of economic conditions: low inflation, high unemployment, and stagnant economic growth coexisting with high and volatile interest rates.

Figure 6

THE FEDERAL DEFICIT

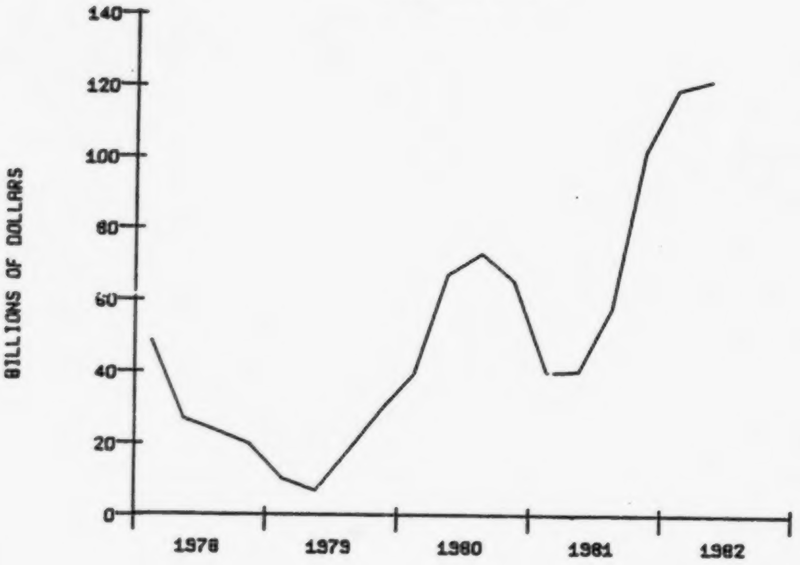


Figure 7

FEDERAL DEFICIT AS A PERCENT OF PERSONAL SAVINGS

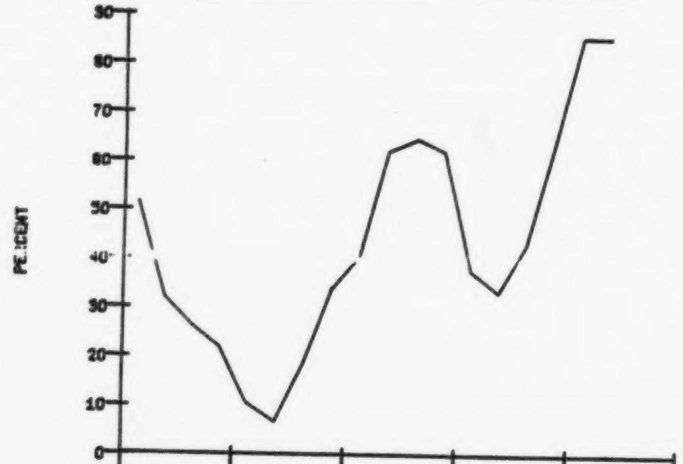


Figure 8

FEDERAL DEFICIT AS A PERCENT OF PERSONAL SAVINGS PLUS CORPORATE SAVINGS

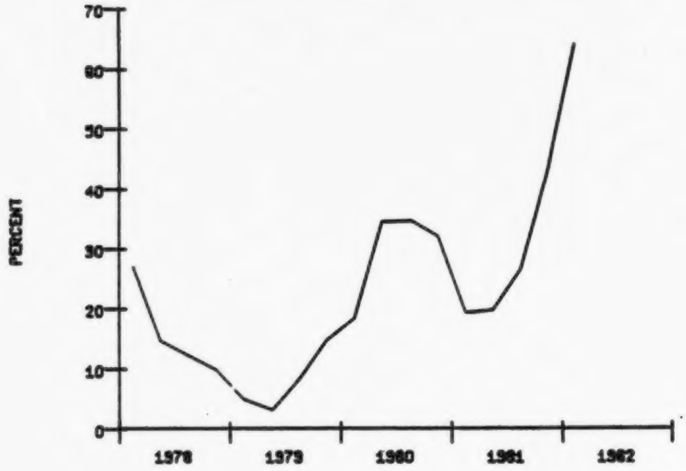


Figure 9

FEDERAL DEFICIT AS A PERCENT OF TOTAL PRIVATE SAVINGS

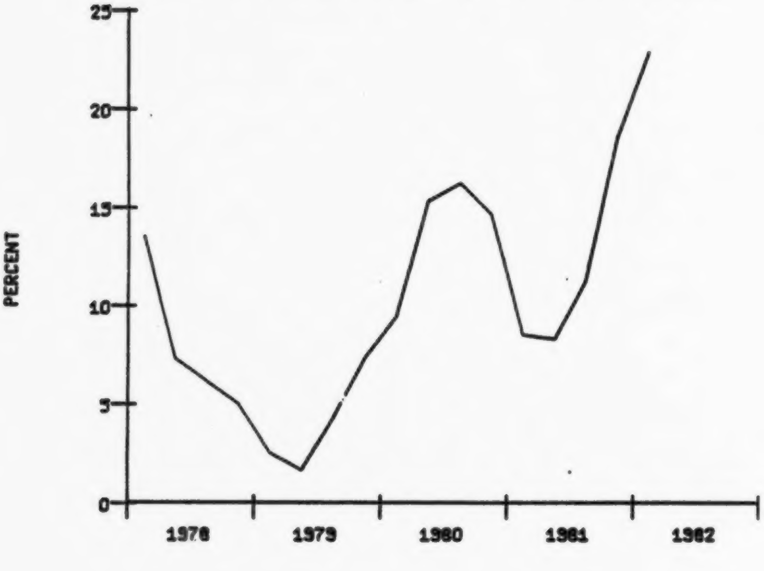
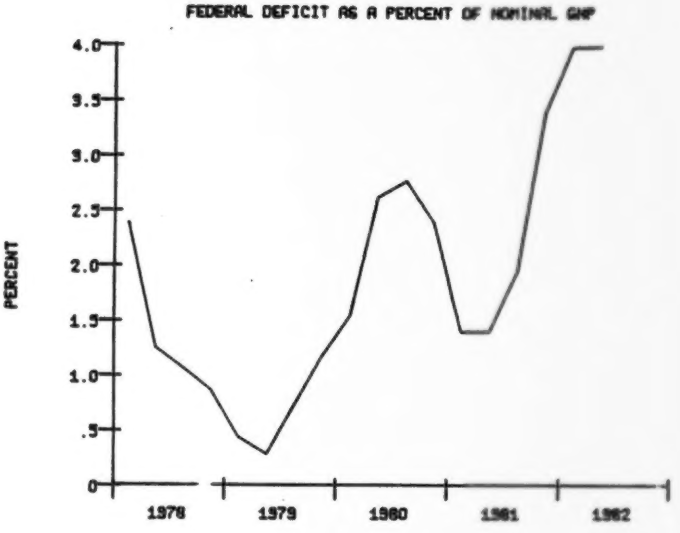


Figure 10



FEDERAL DEFICIT AS A PERCENT OF NOMINAL GNP

The adjustments forced on private borrowers have, in some cases, been unprecedented since the Great Depression, and no industry has suffered more than the housing industry. For forty months now, housing activity has declined, and this decline has accelerated during the last twelve months. More Americans during the last forty months have lost the opportunity to satisfy their home owner needs than at any other time in United States history. This includes the drop through the years 1929 to 1933. Home sales have fallen 55 percent (from peak to trough) in dramatic and stark contrast to the physical volume of other sales in the national economy which have dropped only about three percent. About 3.5 million households have been denied the opportunity to qualify for adequate housing of their own.

Figure 11

HOUSING STARTS AND HOME SALES

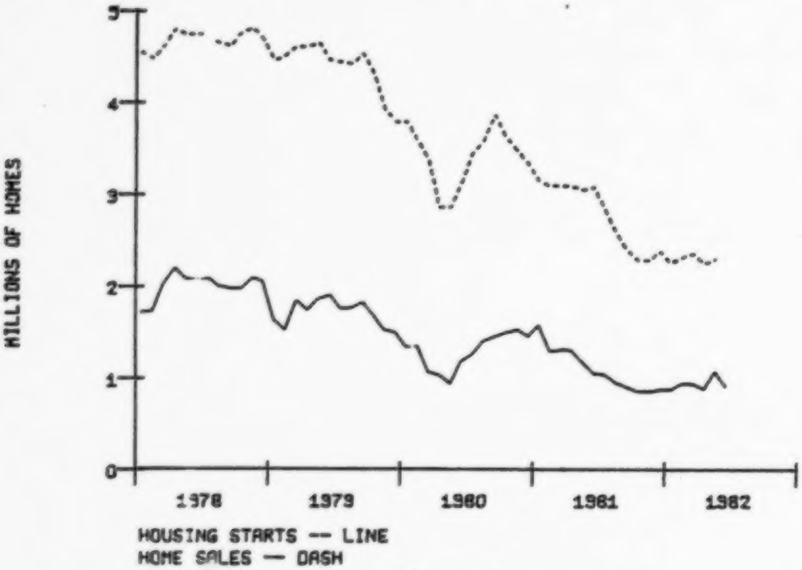
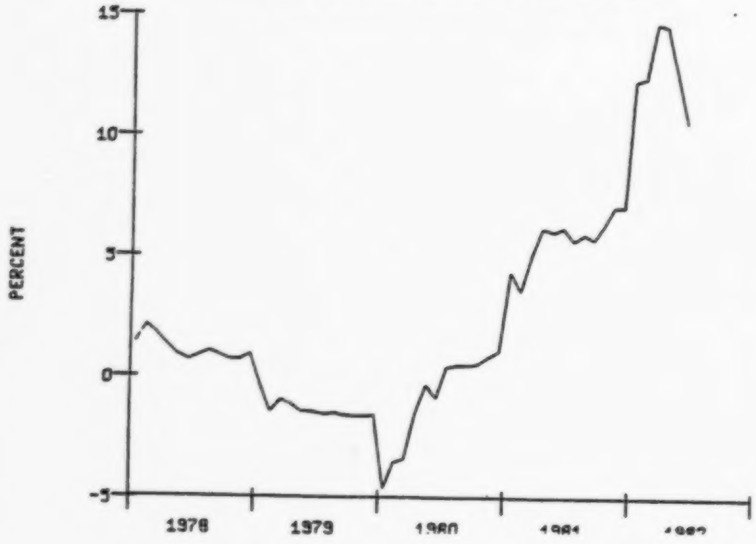


Figure 12

REAL EFFECTIVE CONVENTIONAL MORTGAGE RATE



This loss has occurred while the demographic demand for housing is not significantly decreasing, even before considering replacement demand. The loss has not only kept would-be home buyers from achieving their dream of home ownership, but has caused home owners to lose as much as one-half of their investment in their homes. This loss occurred because real interest rates for new mortgages (interest rates after adjusting for inflation) have increased from the normal three percent level during the post-war period to highs of of 6.9 percent during 1981, near 15 percent in 1982, and 8.2 percent forecast for 1983.

The higher real interest rates, rising from three percent to above 14 percent, have caused a loss of at least 25 percent of the current marketable value of every American's home, as well as any other long-lived investment such as commercial, industrial, and agricultural real property. When one considers the average equity of people's homes is sixty percent, this means nearly one-half of all Americans' equity in their homes has been taken away because of high real interest rates resulting from this policy conflict.

Along with housing, other credit sensitive industries have been caught in the jaws of this policy conflict. The auto industry and other consumer durable goods industries are heavily affected. Industries that support housing and consumer durable goods such as lumber, steel, plastics, rubber, and others have suffered severe declines. With the general decline in output, and also because of the high cost of funds, investment in plant and equipment has fallen drastically. Prolonged depression in investment in housing and business structures and equipment will virtually guarantee high prices and lagging productivity in the future.

Figure 13

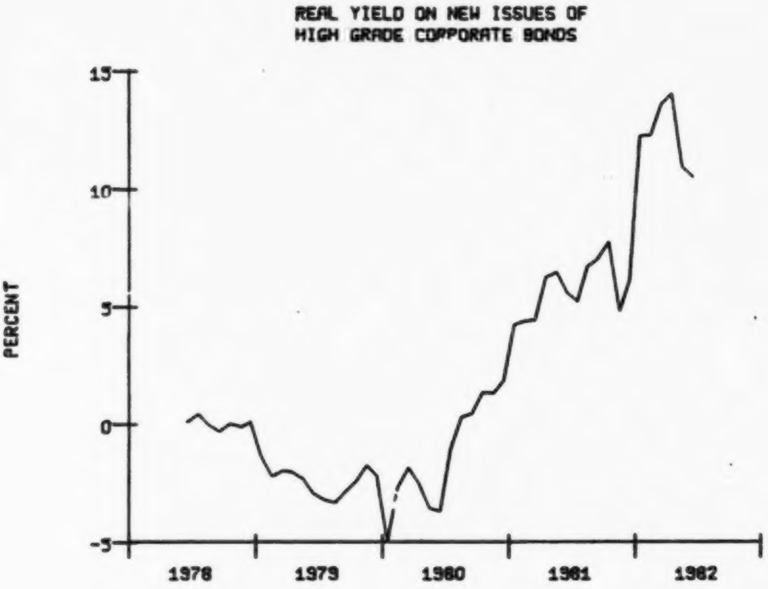
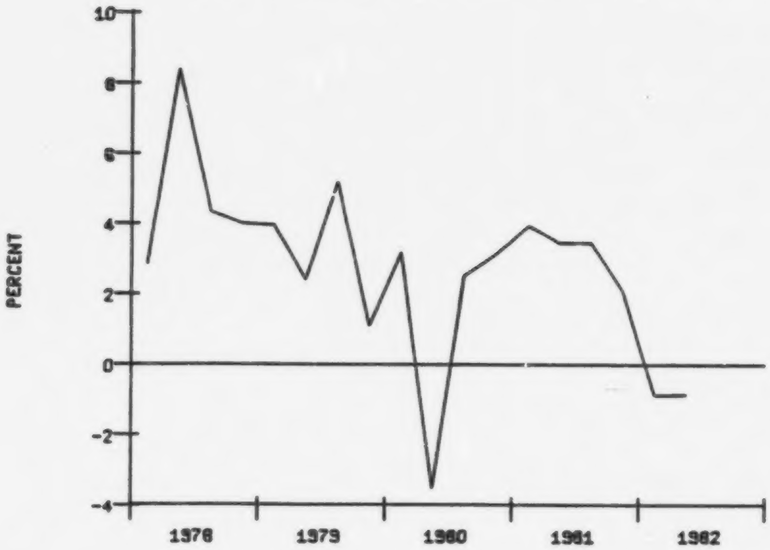


Figure 14

PERCENT CHANGE IN NONRESIDENTIAL INVESTMENT



It has always been known by all of us that the fight against inflation would not be an easy one. There was to be suffering by many in order to achieve price stability. But the method of solely relying on monetary policy as the tool to obtain price stability has resulted in the casualties being predominantly distributed in the credit sensitive industries. Nevertheless, substantial progress has been made in reducing the cost of production and there is now opportunity for strong sustained economic growth with more suitable prices.

Along with the fall in prices, real incomes have been steadily growing. Consumers have been liquidating their debt and the debt service to income ratio is the lowest it has been in years. Although there has been some increase in the consumer price index lately, the increases have been centered on energy and housing costs and there are reasons to believe this accelleration will be short-lived, or are the results of statistical quirks. Energy surpluses are beginning to build again as energy producers renig on OPEC production agreements. This may limit future increases in oil prices. The rise in home prices lacks credibility given the current depressed housing market leading to an upward bias in measured inflation. On a more optimistic side, producer prices for finished and intermediate goods, as well as crude materials, continue to be moderate and give reason for optimism that the growth in prices in the future will be moderate. Wage demands have finally begun to moderate with actual wage declines being registered in some cases and capacity utilization is extremely low. These indicate that renewed growth will not be inflationary. The dollar's position on the international currency markets is currently too strong, but should trend toward an appropriate lower value in relation to other currencies as our interst rates decline. Nevertheless, its continued strength will also help keep renewed economic growth noninflationary. Finally, our current confused economic state has driven investors to cautious liquid positions so they are now poised and capable of investing in the new opportunities that would arise in a recovery.

Figure 15

PERCENT CHANGE IN PRODUCER PRICES AND AVERAGE HOURLY EARNINGS

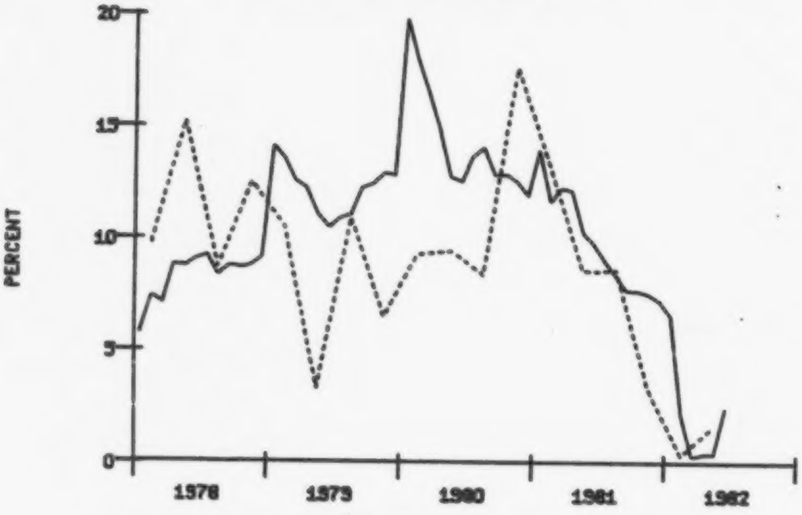
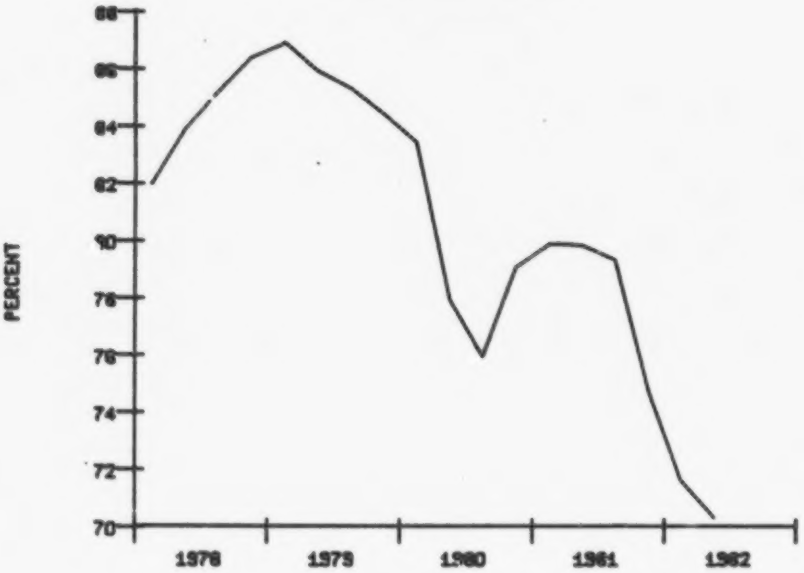


Figure 16

PRODUCER PRICES — LINE
AVERAGE HOURLY EARNINGS — DASH

CAPACITY UTILIZATION



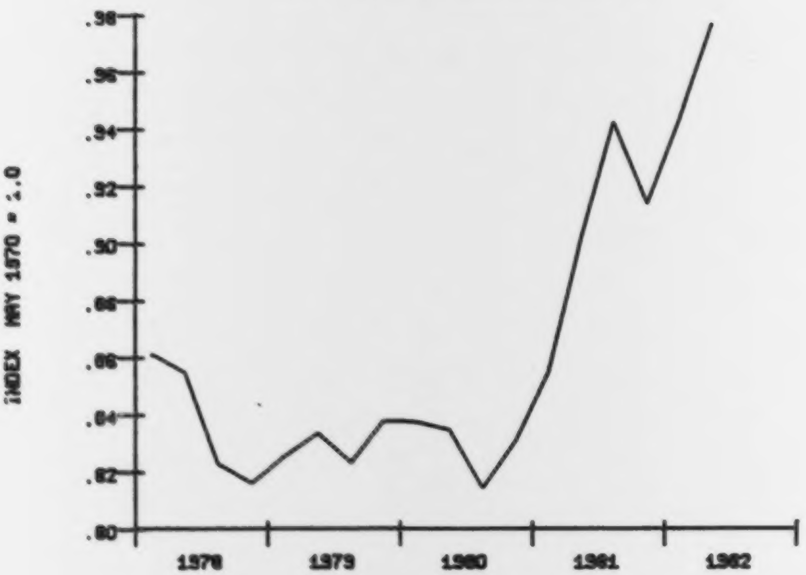


Figure 17

U.S. TRADE-WEIGHTED EXCHANGE RATE

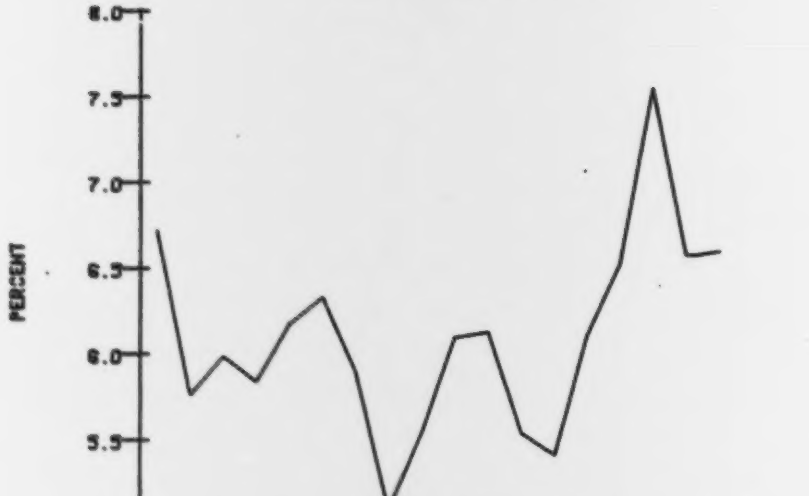


Figure 18

PERSONAL SAVINGS RATE

However, there will be no strong and sustained recovery until the conflict between fiscal and monetary policy is removed. The economy is now at a crossroad. One road leads to economic recovery and prosperity. The other to depression as the many businesses that have survived so far begin to fail when interest rates do not come down and a recovery does not occur. The way to get on the right road is not now in dispute. Just as the national consensus two years ago was that controlling inflation was the nation's top economic priority, the consensus is now for reducing the federal deficit and borrowing, lowering interest rates, increasing employment and raising the standard of living of Americans. Although the recent budget resolution has been a step in the right direction, we agree with Federal Reserve Chairman Volcker in saying that there has to be far more done on the fiscal side in reducing deficits before a sustained and robust economic recovery can ensue. This is particularly the case if the Congressional Budget Office is correct in saying that even with the expenditure cuts and tax increases in the latest budget resolution, federal deficits will be near $140 to $155 billion over the next three years. This state of affairs simply cannot be allowed to continue.

Reduction of the federal deficit is crucial if economic disaster is to be avoided. In order to bring about this reduction, I sincerely request you give consideration to the recommendations of the NATIONAL ASSOCIATION OF REALTORS® which are:

(1) Federal spending growth must be slowed down and reduced in all parts of the federal budget, including defense, entitlement programs, and other programs. Spending this year has overrun the commitments of the President and the Congress by double the rate compared to the last ten years. REALTORS ® have been responsible for recommending many of the cuts which were subsequently proposed by the President and enacted by the Congress last year that affected real estate and we called upon other industries to follow our example of accepting the necessary sacrifices.

(2) Deferral of tax relief planned for July 1983 and indexing scheduled for 1984 should be considered among ways to meet this need.

(3) Tax increases to discourage consumption, but not savings and investment, should be adopted along with spending reductions to help limit the deficit. REALTORS ® in the first place recommended individual tax relief should be limited to five percent across the board each year, instead of ten percent, and that the tax relief should be no larger than spending reductions to achieve a balanced budget by 1984.

(4) Finally, we recommended that Congress adopt a Constitutional Amendment to restrain the growth of federal pending and taxes in relationshiop to the growth of people's income and to restrain the growth of deficits.

Although reduction in the federal deficit has priority over the range of policy options, improvement in the exercise of monetary policy is also of high importance. Interest rates have been extremely volatile since the Federal Reserve began targeting money growth as its primary policy objective. Also, partly as a result of this concentration on money growth targets, real interest rates have reached prohibitive levels even though inflation has sharply declined. Monetary policy improvements must address these problems of interest rate volatility, the formation of erroneous policy expectations with respect to money growth, and prohibitively high real interest rates. These will be the issues to which our recommendations on monetary policy improvements will be addressed.

With respect to the volatility of interest rates, we know that increased rate volatility is an inherent consequence of the policy technique of targeting money growth. However, the excessive magnitude of the volatility we have experienced has resulted primarily from an unnecessarily erratic growth path in the money supply. Excessive interest rate volatility is a major factor in depressing credit dependent industries. The Federal Reserve's capacity to control the supply of credit in order to produce a steadily growing money supply and stable interet rates has been demonstrated to be limited.

Techniques of controlling the monetary aggregates have been discussed and the current policy of lagged reserve requirements has received considerable attention. Under lagged reserve requirements, required reserves are to be met with a two-week lag. That is, for average end-of-day deposits during a given seven-day computation week, reserves are to be held during a seven-day maintenance week ending fourteen days after the end of the computation week. Vault cash also is lagged two weeks. That is, vault carh held during the computation week is to be used to satisfy reserve requirements during the maintenance week two weeks later. Also, member banks could not only make up reserve deficiencies in the next reserve maintenance week, but could carry forward excesses into the next maintenance week. This last provision, which is called the carry-over provision, obviously complicated reserve accounting.

Studies by the staff of the Federal Reserve found, as reported in a staff paper to the Board of Governors on September 14, 1981, that there was widespread support for lagged reserve requirements (LRR) among depository institutions because it reduced the costs to banks of acquiring current data on their required reserved in time to adjust their reserve positions. However, LRR added to the size of these adjustments for banks clearing through the Federal Reserve. Movements in reserves over the maintenance week are typically accompanied by movements in deposits in the same direction, and with contemporaneous reserve requirements (CRR), changes in excess reserves are partially offset by the associated changes in required reserves. In contrast, with LRR this offset does not occur and necessitates larger reserve adjustments at the end of each maintenance week.

The study continues by saying that reflecting these additional adjustments, which are made in part via the federal funds transactions and member bank borrowing, LRR added somewhat to pressures for fluctuations in the federal funds rate near the end of the maintenance period. Accordingly, the volume of system defensive open market operations needed to constrain settlement day fluctuation in the funds rate increased.

Finally, the staff report says LRR has no discernable impact on the precision of monetary control under a federal funds rate operating target, which relied mainly on influencing money demanded. However, under a reserve operating target, LRR impairs short-run monetary control by delaying the response of money market interest rates to changes in the quantity of money demanded. For example, with fixed weekly targets for reserves, the switch to CRR would speed up the impact of changes in money or required reserves and interest rates by two weeks. Empirical evidence comparing the relation beteen reserves and money in the years before and after the switch to LRR suggested that month-to-month monetary control could be noticeably improved under reserves targeting by a return to CRR.

Also included in the paper were the recommendations of the staff which state that the return to CRR would entail substantial start-up and continuing costs for both depository institutions and the Federal Reserve System. It would also be considerably more complex administratively, particularly for reserve pass-through relationships, than the present lagged reserve requirement system. Nonetheless, the staff is of the view that a CRR system as proposed in their memorandum is operationally feasible. With regard to the benefits of such a system, CRR would offer the potential for improved month-to-month control over the monetary targets, though the monetary control gains would be appreciably less over longer periods, say a three to six month horizon.

The staff went on to recommend a CRR system with the following features:

(1) Only depository institutions reporting deposits weekly would be subject to CRR.

(2) CRR would apply only to transactions deposits; reserve requirements on other reservable liabilities would continue to be met on a lagged basis.

(3) Vault cash holdings in a previous period would continue to be counted as reserves in the current maintenance period.

(4) The computation period for transactions balances would end on Monday, two days before the end of the maintenance period.

(5) Both the computation and maintenance periods would be two weeks in length rather than the present one week. However, for purposes of the monetary statistics and the estimation of required reserves, deposits would continue to be reported on a weekly basis.

(6) The current carryover limit of plus or minus two percent of daily average required reserves would seem appropriate.

The NATIONAL ASSOCIATION OF REALTORS ® endorses the recommendations of the Federal Reserve staff and requests that this committee encourages the Federal Reserve to set a suitable date for implementation.

The unusual economic conditions and regulatory, attitudinal, and technological evolution, have all made the art of monetary management very difficult. The current economic conditions have confused the expectations of investors and consumers and they have responded to this by holding large amounts of liquid assets. New financial instruments that have been developed having characteristics of both transaction accounts and savings accounts are now widely available to the public, and current conditions are causing them to use these accounts in new ways. Since the monetary aggregates that are targeted for policy purposes are defined on the basis of accounts that segregate the transaction and saving functions, setting policy based on those aggregates is sometimes difficult to sustain and more importantly for short run interest rates, difficult to interpret.

Chairman Volcker has testified, "the great bulk of the increase in M1 during the early part of the year--almost 90 percent of the rise from the fourth quarter of 1981 to the second quarter of 1982--was concentrated in NOW accounts, even though only about a fifth of total M1 is held in that form." He also states, "In contrast to the steep downward trend in low interest savings accounts in recent years, savings account holdings have stabilized or even increased in 1982, suggesting the importance of a high degree of liquidity to many individuals in allocating their funds. A similar tendency to hold more savings deposits has been observed in earlier recessions."

In the Federal Reserve's Midyear Monetary Policy Report to Congress it states, "Looking at the components of M2 not also included in M1, the so-called non-transaction components, these items grew at a 10-3/4 percent annual rate from the fourth quarter of June 1982. General purpose and broker/dealer money market mutual funds were an especially strong component of M2, increasing at almost a 30 percent annual rate this year. Compared with last year, however, when the assets of such money funds more than doubled, this year's increase represents a sharp deceleration." Money market mutual funds are similar to NOW accounts in that they have characteristics of both transactions and savings accounts. The report continues, "after declining in each of the past four years--falling 16 percent last year--savings deposits have increased at about a 4 percent annual rate thus far this year. This turnaround in savings deposits flows, taken together with the strong increase in NOW accounts and the still substantial growth in money funds, suggests that stronger preferences to hold safe and highly liquid financial assets in the current recessionary environment are bolstering the demand for M2 as well as M1."

This increased demand for M1 and M2 affects the ratio of these aggregates to gross national product. This has policy implications because the determination of whether money growth is excessive or constraining is based on an assumed ratio of the money aggregate to gross national product. An assumed velocity if you will. That is how the target ranges are decided upon.

Chairman Volcker stated, "the Committee (Open Market Committee) was sensitive to indications that the desire of individuals and others for liquidity was unusually high, apparently reflecting concerns and uncertainties about the business and financial situation," he also states, "Judgments on these seemingly technical considerations inevitably take considerable importance in the target-setting process because the economic and financial consequences (including the consequences for interest rates) of a particular M1 or M2 increase are dependent on the demand for money." In other words, the determination of whether money is tight or loose at a particular level depends on the velocity to a considerable extent. In reference to Federal reserve policy early this year when money growth was well above target, Chairman Volcker states "In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregate appeared inappropriate." He continued, "Moreover--and I would emphasize this--growth somewhat above the target ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money." The Chairman also stated that the behavior of velocity and interest rates weighed heavily in this policy determination.

The problem with this is that just as the Federal Reserve's policy decisions on acceptable money growth is complicated by the velocity problem, it is doubly difficult for the members of the financial community who have recently had to trade based on expectations of Federal Reserve policy, to form expectations on that policy. The importance of Federal Reserve policy is indicated by the attention that is paid to the weekly release of the monetary aggregates. This attention has been so great that the expectations formed by them have been of some concern at the Federal Reserve. Recently, the Federal Reserve has said it intends to counter this by averaging the weekly numbers to reduce their volatility and hopefully their importance in forming expectations about Federal Reserve policy.

It is our feeling that this is the exact opposite of the approach the Federal Reserve should take to this problem. Instead of trying to reduce the information available to the financial markets for forming expectations on Federal Reserve policy, they should be increasing it. During the early part of this year expectations of emminent tightening of money growth and higher interest rates were formed because of persistent money growth above Federal Reserve targets. The expectations of higher interest rates inflated long term interest rates and drove long term borrowers into the short term market which helped inflate those rates as well. The statements of Chairman Volcker on the policy considerations of the Open Market Committee at the time indicate that these expectations were overly pessimistic. When the Open Market Committee modified its policy due to velocity and liquidity preference changes, the modification was not effectively communicated to the financial markets. This resulted in erroneous expectations and probably resulted in interest rates being higher than they would have been if policy expectations had been more accurate.

We believe the Federal Reserve should implement measures to reduce erroneous policy expectations in the financial markets particularly as they result from short and medium term policy modifications by the Open Market Committee. Just as the Federal Reserve periodically reports to Congress on Federal Reserve policy and responds to their questions, they should perform a similar function for members of the financial markets. What we propose is that the Federal Reserve hold monthly public briefings in New York and Washington for financial market officials and the public whose opinions weigh heavily in the formation of investor expectations. These briefings should be held soon after each meeting of the Open Market Committee and should be conducted by the Federal Reserve Chairman, a Federal Reserve Governor, or possibly a member of the Open Market Committee. The subject of the meetings would be the short-run targets for money growth of the Committee. Also discussed would be factors which could cause variance from the Committee's targeted growth path and what the likely Committee response to those variances would be.

It is our feeling that such briefings would reduce much of the uncertainty in the financial markets with respect to Federal Reserve policy for management of money growth. This would certainly reduce the impact of volatile movements in the money stock measures on interest rates and could, therefore, reduce the large risk premiums that are currently imbedded in those rates. We strongly encourage this committee to request that the Federal Reserve consider this proposal and report on its feasibility.

Finally, I would like to address the problem of sustained high real interest rates that are enduring despite our current reduced level of inflation. To be sure, the primary policy measure to be taken to remedy this problem is to reduce excessive borrowing by the Federal Government. However, the Federal Reserve must also have a responsibility to help maintain real interest rates at levels necessary to promote growth in output and employment with low inflation and stable prices. The economy, though currently languishing in a deep recession, is now poised for a recovery. With wage growth moderating, capacity utilization low and consumer liquidty high, we now have our best opportunity to initiate a sound recovery with low rates of inflation. Our priorities must now turn to this recovery which will bring the country back to economic prosperity. Monetary policy must do its part to help bring the recovery about, and to continue to play a role in sustaining strong economic growth by keeping real interest rates from reaching excessive levels.

The NATIONAL ASSOCIATION OF REALTORS ® has in the past and continues to support the Federal Reserve's policy of gradual reduction in the rate of growth of money and credit in order to reduce inflation. However, we would like to additionally recommend at this time that this committee consider requiring the Federal Reserve through amendments of the relevant sections of the Federal Reserve Act, to utilize the policy tools at its disposal to maintain real short-term interest rates at historic levels (3 to 4 percent) during any periods of time that the long and short-term monetary monetary growth targets of the Federal Reserve are being met.

The adoption of this proposal would insure that during periods where low inflation and high real interest rates exist while money growth is within the short and long run target ranges of the Federal Reserve, monetary policy would shift in priority from restraining inflation by reducing money growth to encouraging economic growth and higher employment by reducing real interest rates. It is our feeling that current Federal Reserve policy has not been aggressive enough in helping to bring economic recovery even though inflation is low and money is growing at acceptable rates. Our recommendation will ensure that the appropriate monetary policy priorities are being exercised relative to the prevailing economic conditions.

Consistent with this idea of matching policy priorities with prevailing economic considerations, it is our feeling that the Federal Reserve should review its short run monetary growth targets given the high liquidity preferences of the public and the resulting low money velocity. Considering also the low current rates of inflation, the Federal Reserve can now safely allow money to grow at least one percentage point above the current target range for the remainder of this year and through 1983. The result of this would be to further lower interest rates and relieve some of the pressure from interest sensitive industries and thrift institutions. A more rapid economic recovery would surely result from this policy modification. Unfortunately, however, this policy and other Federal Reserve policies to lower real interest rates can not be expected to be maintained unless runaway Federal deficits are brought under control and reduced.

In conclusion, I would like to say that the Federal Reserve must be commended for its effectiveness in reducing inflation in this country. However, the execution of Federal fiscal and monetary policy must be improved and made consistent if we are to have a strong sustained recovery and balanced economic growth with high employment, low inflation, and an increasing standard of living for all Americans. It is to this end that our recommendations are here presented to this committee.